

Internal Audit Techniques

Participants' Handbook
April 2014

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The United Republic of Tanzania

Support to Local Governance Processes (SULGO) in Tanzania
Project: Strengthening internal controls at sub-national level

Internal Audit Techniques

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Foreword

Tanzania's local government budgets account for over 25 per cent of the total national budget – and the proportion is increasing. This trend mirrors the responsibilities that have so far been transferred to LGAs over the past decade under the national decentralisation by devolution policy. At the same time, LGAs are facing ever-increasing demands for quality services and for strict adherence to regulations and transparency, pushed by, amongst others, the National Audit Office as seen in the critical audit opinions it issued to various LGAs.

The effectiveness of LGAs' internal control systems determines not only how public funds are used but also the extent to which local governments are becoming the drivers for development as they are expected to be. Further advancements in the national decentralisation process depend heavily on the way LGAs control the resources they are entrusted with. LGAs' internal control systems also play a key role with respect to the legitimacy of the state because local governments are the institutions closest to the ordinary citizens. Hence, the way the LGAs actually use their resources has a big impact on the public's opinion and perception of the performance of the government as a whole. In the context of rising tensions within a transforming society, the importance of strong LGA internal control systems cannot be overemphasized.

Several government bodies such as the Prime Minister's Office for Regional Administration and Local Government (PMO-RALG), Regional Secretariats (RSs), and the Office of the Internal Auditor General are required to capacitate LGAs in the area of internal controls. Yet, developing capacities for nearly 170 LGAs constitutes an enormous task in addition to the challenges already being encountered as the LGAs attempt to cope with recently introduced higher national standards, such as those relating to risk management or to accrual accounting.

PMO-RALG and GIZ, in close collaboration with the Office of the Internal Auditor General, launched an initiative to assist selected district, municipal and city councils and corresponding Regional Secretariats (RS) in the application of and adherence to internal controls standards and regulations. The focus of this initiative was on learning-by-doing, capacitating public servants through coaching on-the-job, and on formulating respective methods of capacity development at sub-national level.

The present book is a direct outcome of the coaching and forms part of a series that covers the four thematic areas of Accounting & Administrative Controls, Risk Management, Internal Audit and Audit Committees in the councils, as well as the backstopping role of Regional Secretariat in monitoring and evaluation of LGAs' internal controls. Each of the areas comprises two books: a participants' handbook for the public servant for reference, and a handbook for facilitators tasked with capacitating staff from LGAs or RSs.

We wish the users of the present book interesting and stimulating reading and hope that it helps to perform better their tasks.

Achim Blume

Head of GIZ Governance Programmes Tanzania

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List of Abbreviations

CAG	Controller and Auditor General
CIA	Certified Internal Auditor
GAIN	Global Audit Information Network (The)
HIAU	Head of Internal Audit Unit
IAF	Internal Audit Function
IAGD	Internal Auditor General's Division
IAU	Internal Audit Unit
IIA	Institute of Internal Auditor (The)
INTOSAI	International Organisation of Supreme Audit Institutions
IPPF	International Professional Practices Framework
ISACA	Information System Audit and Control Association
IT	Information Technology
LAFM	Local Authorities Finance Memorandum
LGA(s)	Local Government Authority(ies)
MDA	Ministries, Departments and Agencies
NAOT	National Audit Office of Tanzania
NBAA	National Board of Accountants and Auditors
PC	Personal Computer
PMO-RALG	Prime Minister's Office – Regions Administration and Local Government
QAIP	Quality Assurance and Improvement Program
RAS	Regional Administrative Secretariat
SULGO	Support to Local Governance Programme (GIZ)
TAS	Tanzania Accounting Standards
TORs	Terms of Reference
VFM	Value for Money

Introduction to the Handbook

Background Information

This Participant's Handbook on Internal Audit Techniques has been developed as part of the Project "Strengthening internal controls at sub-national level" under the GIZ Programme "Support to Local Governance Processes" (SULGO). The project's objective is: "The internal control mechanisms at selected LGA level in the two partner regions of the programme, Mtwara and Tanga, are reinforced". The project supports the Tanzanian Local Government Reform Programme as one of the major national strategies promoting the decentralization process.

The project covers four (4) key thematic areas; (1) risk management; (2) accounting and administrative controls; (3) internal audit techniques and (4) functioning of the audit committees. Each thematic area has its own coaching materials in form of one participants' and one facilitators' handbook. The coaching curriculum for each of the thematic area was developed based on the coaching needs assessment of beneficiaries, documentary review on CAG audit reports, management letters and on the study "Priority Entry Points to Strengthen Accountability and Internal Auditing at District level" from 2012.

Use of the Participants' Handbook

This handbook was first used as a coaching aid when coaching sessions were conducted to officials in the four pilot LGAs, i.e. in Handeni District, Tanga City, Mtwara District and Mtwara Municipal Council.

After the coaching has ended, the handbook can be further used as reference and guidance document, e.g. for clear definitions of technical terms, for step-by-step explanations of processes, for checklists or for the correct use of templates and reporting formats.

In addition to the coaching participants, the handbook was also developed for officials of other LGAs as a self-learning kit.

Overview of Session Layout and Design

The Participants' Handbook covers 11 main coaching sessions. The layout of the session is composed of an introduction, learning objectives, definitions if appropriate, the session content, some hints and review questions. On successful completion of the 11 sessions, participants will be able to perform their roles and responsibilities.

The coaching sessions have a duration ranging from thirty minutes up to two hours, with the average being one hour. The sessions are to be delivered at a particular LGA in the form of one-on-one sessions, focus group discussion and peer-to-peer learning sessions.

Session 1

1 Introduction to Internal Auditing

1.1 Introduction

Internal audit plays an important role in helping organisations achieve their intended objectives. It has always been viewed as an integral part of organisational governance, and increasingly as an instrument for improving the performance of the organisation, both in private and public sector.

This session therefore discusses general introductory issues on internal audit covering its definition, nature of internal audit work, and some of professional and legal issues affecting the work of internal auditing in LGAs.

1.2 Learning Objectives

By the end of this session the participants should be able to:

- ▶ Define internal auditing and its scope;
- ▶ Explain different types of audit;
- ▶ Explain the nature of internal audit work;
- ▶ Describe the benefits of an effective internal audit in an LGA.

1.3 Definitions of Internal Auditing

What is Internal Auditing?

“Internal Auditing” is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach in evaluating and improving the effectiveness of risk management, control, and governance processes.

The Institute of Internal Auditors (IIA) - 1999

The above definition is given by the Institute of Internal Auditors. However, section 13 (2) of the Local Authorities Financial Memorandum (2009) also defines internal audit as:

“ ... an internal audit is an independent appraisal of internal control within a Local Government Authority done by examining and evaluating the effectiveness and adequacy of such controls.”

This definition is based on the older version of the definition (i.e. prior to 1999) which has a limited scope of the role of internal auditing in LGA namely the appraisal/evaluation of internal control in LGA.

The adoption of the IPPF in Tanzania (see session 3) has rendered this definition to be outdated, hence the expansion of the Internal audit role (see session 2) to include the provision of assurance and consulting services (as opposed to appraisal services) of three main but related areas:

- ▶ Risk management;
- ▶ Control; and
- ▶ Governance processes.

Session 2 discusses this broad role of internal auditing in LGAs.

1.4 Nature of Modern Internal Auditing

According to Sawyer et al (2005), the definition has five (5) key concepts that shape the nature of today's internal auditing:

- i. **Independence** – the internal audit activity must be free from interference in determining the scope of internal auditing, performing work and communicating results;
- ii. **Objective assurance** – internal audit provides an independent and objective opinion to LGA management as to whether it is achieving its objectives and receiving value for money and that risks are being managed to acceptable levels. It can be provided in-house or be outsourced;
- iii. **Consulting activity** – the internal audit activity encompasses provision of professional advice to LGA management i.e. an underlying professional competence that is used in making judgments about a given situation and relied on by the user of the consultant's advice;
- iv. **Add value** – the internal audit activity should contribute to the overall improvement of the LGA operations. Thus, internal auditors make value-added contributions throughout the entire audit process and in almost every aspect of their work;
- v. **Risk management, control and governance processes** – its scope has widened, it is not just the audit of financial processes, but it is more concerned with key issues in control, risk management, and governance.

1.5 Legal Context of Internal Audit in LGAs

The practice of internal auditing in Tanzanian public sector (i.e. MDAs and LGAs) is governed by both professional standards (see next session) and government regulations.

The establishment and maintenance of an Internal Audit Function in LGAs is provided for under section 45 (1) of the Local Government Finance Act No.9 of (1982).

The position of Internal Audit Function in an LGA is also given or provided in the Local Authority Financial Memorandum (LAFM) of 2009. Order No 13 of the LAFM states:

“In accordance with section 48 of the Local Government Finances Act the Council shall employ its own Internal Auditors who shall work closely with the HODs and shall report directly to the accounting officer.”

However, the overall performance of internal audit activities in LGAs is affected/governed the following laws, regulations, standards and circulars:

- i. Public Finance Act (2001) as revised in 2004 and amended in 2010;
- ii. Local Government Finances Act (1982);

- iii. Public Finance Regulations (2001);
- iv. Local Authority Financial Memorandum (2009);
- v. Internal auditing standards and guides set out in the International Professional Practice Framework (IPPFs) issued by the IIA;
- vi. Code of Ethics for Internal Auditors issued by the Internal Auditor General;
- vii. Circulars issued from time to time by the Permanent Secretary, Ministry of Finance (MOF) as well as the Internal Auditor General (IAG);
- viii. Circulars issued from time to time by the Permanent Secretary, Prime Minister's Office-Regional Administration and Local Government (PMO-RALG).



The NBAA's withdrawal of TAS. No. 9 adoption of the IIA's IPPF as standards for Internal Auditing has led to the adoption of the IIA's definition even in LGAs, hence widened the scope of internal audit work in LGAs.

This adoption led to the review of internal audit manuals by the IAG so as to accommodate new issues from the IPPF e.g. definition, risk-based audit, review of risk management and governance processes (see the New Internal Audit Manual in LGAs by the Ministry of Finance).

1.6 Review Questions

- i. What is internal auditing? Explain the key features/issues contained in the definition of internal auditing.
- ii. What do you think is the effect on the performance of internal audit emanating from the existing differences in definitions (i.e. between the IIAs and the Memorandum) of internal auditing?
- iii. Explain the main legal and regulations that govern internal audit works in LGAs
- iv. Describe the internal audit reporting lines that exist in the LGA.

Session 2

2 Value Adding Role of Internal Audit

2.1 Introduction

Internal audit activity plays a significant role in the achievement of LGA's objectives. Its expanded scope of activities and professionalism has made it to be among the key functions in public sector management and as the right hand of most of the executive directors.

This is discusses some of the key “value adding” roles that an effective internal audit unit can play and help their LGAs to achieve their objectives.

2.2 Learning Objectives

At the end of this session the participant will be able to:

- ▶ Define assurance and consulting services;
- ▶ List different internal audit customers and stakeholders;
- ▶ Explain the internal audit roles and responsibilities in LGAs;
- ▶ List the features of an effective internal audit unit.

2.3 Definitions

The following definitions are essential in this session:

Assurance:

A positive declaration on an audit objective. Assurance can cover a wide range of matters, from the fair presentation of financial statements to the effective operation of internal controls.

Consulting:

The providing of expertise or specialist advice. Consulting performed by auditors tends to focus on improvements to procedures and processes, in contrast to compliance auditing.

Stakeholder:

An individual or institution, or a group of individuals or institutions, with direct or indirect interest in an organization's activities.

Source: O'Regan (2004) Auditor's Dictionary

2.4 Internal Audit Stakeholders in LGAs

Internal Audit Unit has a multiple stakeholders. For example, Section 48 of the Local Government Finances Act stipulates and Section 14 (1 to 10) of the Financial Memorandum (2009) mentions a number of officials and organs that internal audit units have to work with.

Specifically, Internal Auditor Units interacts in one way or another with the following:

- ▶ Executive Director (i.e. the Accounting Officer);
- ▶ The Audit Committee;
- ▶ The Council (through the Finance Committee);
- ▶ Heads of Department and Units;
- ▶ External Auditors (i.e. the CAG);
- ▶ Minister and Permanent Secretary (PMO-LARG);
- ▶ Regional Administrative Secretary (RAS).

Each of these stakeholders view the value of internal audit based on their needs and how internal audit meets them.

Table 1 below presents a view of two groups of stakeholders and their internal audit value perceptions.

Table 1: Internal Audit Customers with Different Value Demands

Council/Finance Committee/Audit Committee/Director	Operating Management (Head of departments/units)
Interested in: <ul style="list-style-type: none"> ▶ Safeguarding LGA resources, ▶ Compliance of laws and regulations; ▶ Reliability of data. 	Interested in: <ul style="list-style-type: none"> ▶ Value for money of operations (i.e. economy, effectiveness, and efficiency); ▶ Achievement of objectives and targets.
Value Needed: <ul style="list-style-type: none"> ▶ Internal Audit to improve quality of Information. 	Value Needed: <ul style="list-style-type: none"> ▶ Internal audit to become agent of change.

2.5 Value of Internal Audit Units to Stakeholders

As seen in the previous section, internal audit stakeholders have different needs due to their diversity.

In this case, to be seen to be adding value, internal audit units in LGAs must understand the objectives each of these groups of stakeholders and strive to meet them through its activities.

The IIA (2014) summarises the concept of value addition as what internal audit stakeholders should expect from their internal audit units. This is given in Figure 2.

Figure 1: What Customers Expect from Internal Audit Units? (The IIA, 2014)



Consistent to the internal audit definition, internal auditing provides assurance, insight and objectivity.

2.5.1 Assurance

Internal audit provides assurance on LGA's governance, risk management, and control processes to help the LGA achieve its strategic objectives, operational, financial, and compliance objectives.

2.5.2 Insight

Internal auditing is a catalyst for improving an organization's effectiveness and efficiency by providing insight and recommendations based on analyses and assessment of data and business processes.

2.5.3 Objectivity

With commitment to integrity and accountability, internal auditing provides value to governing bodies (i.e. the Council) and senior management as independent source of objective advice.

2.6 Attributes of Successful Internal Auditors

Chambers and McDonald (2013) summarises the following to be the key attributes of a successful internal auditors:

- i. **Integrity** – Internal auditors must possess the confidence, trustworthiness and resilience to handle a variety of complex situations.
- ii. **Relationship-building** – In building solid relationships, internal auditors can develop a better understanding of the LGA's operations, systems and risks, thereby making more valuable contributions.
- iii. **Ability to partner** – Positive relationships creates the foundation for partnering with LGA management and operational leaders.
- iv. **Communication abilities** – Writing concise, compelling reports is only one aspect of being a good communicator. Speaking, listening and finding the best way to visually present data are necessary to be effective in an internal audit role.
- v. **Teamwork** – Teamwork applies to the ability to work well with one's departmental colleagues. The highly integrated nature of the LGA processes examined by internal auditors requires intensive collaboration among professionals with different areas of technical expertise.
- vi. **Openness to diverse perspectives** – Today's LGA workforce includes people of different backgrounds, generations, experiences and skill levels. Internal auditors who have a global mind-set and can view issues through multiple perspectives are highly valued.
- vii. **Commitment to continuous learning** – Professionals who are dedicated to lifelong learning position themselves for more successful careers because they are able to quickly adapt to change.

2.7 Review Questions

- i. Define the terms assurance, consulting and stakeholders in view of your internal audit unit in the LGA.
- ii. List the stakeholders of your internal audit unit with their specific demands (apart from those listed in the session).
- iii. Explain the value added by your internal audit unit in view of the IIA concept of assurance, insight, and objectivity.
- iv. List the other attributes that you think are needed for an effective internal audit unit.
- v. Discuss the different challenges that your internal audit unit may face when addressing the different demands of its stakeholders in your LGA.

Session 3

3 Internal Audit Professional Practice

3.1 Introduction

Internal audit is a fully fledged profession just like other professions (e.g. accounting and external auditing). This session is meant to expose participants to key issues that enable them to maintain a professional practice of internal auditing, which included the need to have an audit charter, conformance to International standards and code of ethics, and other professional guidance.

3.2 Learning Objectives

At the end of the session, participants should be able to:

- ▶ Understand the key features that make internal audit to be a professional activity;
- ▶ Define and explain the Internal Audit Standards;
- ▶ Explain the Code of Ethics;
- ▶ Explain the need for Internal Audit Charter.

3.3 Definitions

The following definitions are important in this session:

Standards

The Standards are principles-focused, mandatory requirements consisting of two parts: (i) Statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of performance, which are internationally applicable at organizational and individual levels; and (ii) Interpretations, which clarify terms or concepts within the Statement.

Source: The IIA (2011)

Ethics

Systematic moral judgments and principles of intrinsic value. They are central to the credibility of professions [...] and are often formalized in written codes of practice.

O'Regan (2004) Auditor's Dictionary

3.4 Need for Maintaining Professionalism

Maintaining internal audit professionalism is both legal and professional requirement. The Financial Memorandum (2009) stipulates that:

“Internal auditor shall always perform his duties professional [...] Failure to observe professional ethics shall lender the auditor personally responsible for any faulty conclusion arising from that audit”.

To maintain internal audit professionalism, the IIA has issued the International Professional Practices Framework (IPPF) which, among other components, contains the Standards and Code of Ethics which all internal auditors must conform to.

As explained in the next sections, the IIA's IPPF has been adopted in the Tanzanian public sector, hence applicable to LGAs.

3.5 Features of Internal Audit as a Profession

Internal audit is now a complete profession which has divorced itself from its accounting background. Its profile has grown in recent years due to more demand for internal assurance and the use of competent.

The following are the main features that make internal auditing to be a complete profession are:

- i. It represents a Common Body of Knowledge which its members acquired through training;
- ii. It has a governing/authorities body (i.e. the IIA) which issues Standards, Code of Ethics and other guidance;
- iii. Its members need to be certified (e.g. Certified Internal Audit – CIA); and
- iv. It offers unique service to society (e.g. in private sector, in MDAs and LGAs etc.).

According to Pickett (2005) Internal audit meets most of the above features and therefore is now firmly established as a professional discipline.

3.6 Overview of the IPPF and its Adoption in Tanzanian Public Sector

The IIA's International Professional Practices Framework (IPPF) is the authoritative guidance on the internal audit profession.

The IPPF presents internationally consistent mandatory and strongly recommended guidance for the practice of internal auditing anywhere in the world.

3.6.1 Adoption of the IPPF in Tanzania

It is a requirement of the Tanzanian government that all Tanzania Internal Audit Services perform their duties in accordance with International Professional Practice Framework (IPPF) issued by the Institute of Internal Auditors (IIA).

This follows the adoption of the IPPF by the Government through the National Board of Accountants and Auditors (NBAA) on 1st July, 2011 (and the automatic withdrawal of TAS No. 9).

Therefore, all LGAs must perform their duties in accordance with the International Professional Practices Framework (IPPF).



The Institute of Internal Auditors (IIA) has its Chapter in Tanzania. The Chapter assists in all professional issues of members and non-members in Tanzania. This includes membership, professional certification (for CIA examinations), training and other resources.

For more information and internal audit updates visit: www.iiatanzania.org or www.theii.org

3.6.2 Components of the IPPF

The IPPF is composed of two major parts namely:

- i. **Mandatory Guidance:** – which comprises of:
 - ▶ The Definition of Internal Auditing (discussed in Session 1),
 - ▶ The Standards, and
 - ▶ Code of Ethics.
- ii. **Strongly Recommended Guidance:** – which comprises of:
 - ▶ Position papers (which are designed to assist a wide range of interested parties, including those not in the internal audit profession, in understanding significant governance, risk, or control issues, and delineating the related roles and responsibilities of internal auditing).
 - ▶ Practice Advisories (they are to assist internal auditors in applying the Definition of Internal Auditing, the Code of Ethics, and the Standards, and promoting best practices), and
 - ▶ Practice Guides (they provide detailed guidance for conducting internal audit activities. They include processes and procedures, tools and techniques, programs, and step-by-step approaches, as well as examples of deliverables.

The IPPF is updated by the IIA from time to time so as to accommodate changes and to bring more improvement to the professional practice of internal auditing across the world.



Most of these documents (i.e. definitions, standards, code of ethics, etc.) are available for download free of charge from the IIA's website i.e. www.theii.org

3.7 Internal Audit Standards

3.7.1 Purpose of the Standards

The purpose of the **Standards** (as provided in the IPPF-2011 updated 2012) is to:

- i. Delineate basic principles that represent the practice of internal auditing;
- ii. Provide a framework for performing and promoting a broad range of value-added internal auditing;
- iii. Establish the basis for the evaluation of internal audit performance;
- iv. Foster improved organizational processes and operations.

The **Standards** employ terms that have been given specific meanings that are included in the Glossary. Specifically, the **Standards** use the word “must” to specify an unconditional requirement and the word “should” where conformance is expected unless, when applying professional judgment, circumstances justify deviation.

It is necessary to consider the Statements and their Interpretations as well as the specific meanings from the Glossary to understand and apply the **Standards** correctly.

3.7.2 Types of Standards

The structure of the **Standards** is divided between Attribute Standards, Performance Standards and; Implementation Standards.

- i. Attribute standards
 - ▶ Attribute Standards address the attributes of organizations and individuals performing internal auditing. They are numbered in 1000.
 - ▶ There four (4) attribute standards- Purpose, Authority and Responsibility (1000); Independence and Objectivity (1100); Proficiency and Due Professional Care (1200) and Quality Assurance and Compliance (1300).
- ii. Performance Standards
 - ▶ The Performance Standards describe the nature of internal auditing and provide quality criteria against which the performance of these services can be measured. They are numbered in 2000. There are seven (7) performance standards: Managing the Internal Audit Activity (2000); Nature of Work (2100); Engagement Planning (2200); performing the Engagement (2300); Communicating Results (2400); Monitoring Progress (2500) and Resolution of Management's Acceptance of Risks (2600).
- iii. Implementation Standards
 - ▶ Implementation Standards are also provided to expand upon the Attribute and Performance standards, by providing the requirements applicable to assurance (A) or consulting (C) activities.
 - a) Assurance services involve the internal auditor's objective assessment of evidence to provide an independent opinion or conclusions regarding an entity, operation, function, process, system, or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor. There are generally three parties involved in assurance services:
 - ▶ The person or group directly involved with the entity, operation, function, process, system, or other subject matter – the process owner;
 - ▶ The person or group making the assessment – the internal auditor;
 - ▶ The person or group using the assessment – the user.

Examples: review of payroll systems, internal controls, cash management systems etc.
 - b) Consulting services are advisory in nature, and are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client. Consulting services generally involve two parties:
 - ▶ The person or group offering the advice – the internal auditor;
 - ▶ The person or group seeking and receiving the advice – the engagement client.
 - ▶ Examples: conducting training on risk management, closure of accounts using IPSAS etc.

3.8 The IIA's Code of Ethics

As provided in the definition section, adherence to the code of ethics is essential to maintain the credibility of the internal audit profession and of individual auditors.

Sawyer's (2012) considers ethics as key to the trust that clients and stakeholders place on internal audit. The violation of such rules of ethical behaviour leads to penalties by peer and the professional body.

The code of ethics (simply termed the Code) applies to all internal audit professionals. It includes two essential components.

3.8.1 Fundamental Principles

All internal auditors are required to abide to the following principles:

- i. **integrity:** The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.
- ii. **Objectivity:** Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.
- iii. **Confidentiality:** Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.
- iv. **Competency:** Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.

3.8.2 Rules of Conduct

The rules of conduct amplify the above Principles but are written such that they give specific guidance for each of the four principles in the form of “shall” and “shall not”.

3.9 The IAG's Code of Ethics for Internal Audit Services in the Public Sector

Apart from the IIA's code of ethics, internal auditors in Tanzania (MDAs and LGAs) are required to adhere to a Code of Ethics (2012) issued by the Ministry of Finance through the Internal Auditor General's Division (IAGD).

The IAG code of ethics builds on the IIA's code of ethics, but now it has customised the same to the Tanzanian public sector.

Of specific emphasis, different from the IIA, is the need for public sector internal auditors to maintain “political neutrality” by keeping internal audit jobs out of their political views.

3.10 Review Questions

- i. IPPF contains the basic elements of the profession, which one is not the purpose of standards:
 - ▶ Delineate basic principle that represent the practices of internal auditing as it should be;
 - ▶ Provide framework for performing a broad range of value added internal audit activities;
 - ▶ Establish the basis for the measurement of internal audit works;
 - ▶ Establish the audit committee of the organization.
- ii. Describe the main types of standards and give examples on how they are applied at your LGA.
- iii. What do you consider to be the challenges (and opportunities) in conforming to the IPPF in the Tanzanian LGAs?

Session 4

4 Developing Risk-Based Internal Audit Plans

4.1 Introduction

It is said that “every successful audit is based on sound planning”. The auditor should plan the audit in a manner that ensures that the audit is carried out in an economic, efficient and effective way and in a timely manner.

This session therefore discusses key issues regarding preparation of risk-based audit plans, both strategic and annual plans.

4.2 Learning Objectives

At the end of this session, participants should be able to:

- ▶ Define the term risk and common risk-factors;
- ▶ Understand the need for risk-based planning;
- ▶ List the types and levels of internal audit plans;
- ▶ Define audit universe and identify auditable areas in their LGAs;
- ▶ Conduct risk assessment of auditable areas for prioritizing auditable areas;
- ▶ Develop strategic and annual plans of their internal audit units.

4.3 Definitions

The following definitions are important in this session:

Risk:

The possibility an event occurring that will have an impact on the achievement of objective. Risk is measured in terms of impact and likelihood.

Source: The Institute of Internal Auditors

Risk Factors:

Condition that can influence the frequency and/or magnitude and ultimately, the business impact of an event/scenarios.

Source: ISACA (2012) Glossary – Knowledge Centre.

Audit Universe:

An audit universe is the aggregate of all areas that are available to be audited within an enterprise.

Source: Moeller (2009)

4.4 Need for Risk-Based Internal Audit Plans

Performance Standard 2010 of the IIA requires the “*Chief Audit Executive to establish risk-based audit plans to determine the priorities of the internal audit activity, consistent with the organization’s goals*”.

This professional requirement is also consistent with stipulations on Section 2 of the Local Authority Financial Memorandum (2009): “*the internal auditor shall prepare the Annual Risk Based Internal Audit plan and submit to the Audit Committee and Accounting Officer for approval.*”

Risk-based approach to audit plan is also more than a professional or legal requirements. The other advantages of using a risk-based approach to internal audit plans include:

- ▶ It helps focus audit effort on areas that matter most (i.e. risky areas of the LGA) hence economic use of audit resources;
- ▶ Improves ability to impact and improve the LGA by targeting the areas that erode value;
- ▶ Generates credibility from management.

4.5 Types and Levels of Internal Audit Plans

Internal auditors usually prepare three levels (types) of audit plans:

- i. Strategic audit plans – covering a period of 3 to 5 years;
- ii. Annual audit plans – covering 1 years/annual plans, broken into quarterly plan;
- iii. Engagement audit plans – covering a specific audit project (e.g. audit of payroll).

Usually these plans are dependent on each other, such that a strategic plan will be a source of an annual planning process, and an annual plan will lead to individual engagement plans. Diagrammatically, the three levels will look like an upside-down triangle (Figure .2).

Figure 2: Levels and Types of Internal Audit Plans



4.6 Defining the Audit Universe and Auditable Areas

4.6.1 Why Define the Audit Universe?

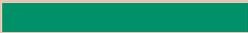
The very first step in audit planning is for internal auditors to define their audit universe. As defined above, the audit universe is the aggregate of all areas that are available to be audited within the LGA. The idea of defining an audit universe is to describe the scope of internal audit’s planned activities.

Purpose of the audit universe is to define the potential scope of an organization’s internal audit activity by segmenting its operations into individual “audit entities” that may be subjected to audit.

4.6.2 Methods for Defining the Audit Universe

According to GAIN (2009) survey report, concluded that internal auditors across the world used different methods in listing their audit universe (see Figure 3).

Figure 3: Grouping of Audit Universe used by Internal Auditors (GAIN Flash Report, 2009)

Response	Chart	Frequency
Department		48.0 %
Function		71.6 %
Risk		40.0 %
Executive		10.5 %
Location		33.1 %
Other (specified below)		21.1 %

However, from Figure 3, the majority of internal auditors base their audit universe on departments or functions in their organisation.

The main tool for this is to understand the LGA structure – (or use the organisation structure) to list the departments and functions/processes within the departments.

Some examples of auditable activities within the audit universe may include:

- ▶ Functions such as purchasing, accounting, finance, marketing and others;
- ▶ Operations and activities within the LGA;
- ▶ Information systems on infrastructure and specific application levels of accounting or administrative processes; or
- ▶ Major contracts or product lines.

The audit universe should be a full list of all possible audits even if there is no intention currently (or insufficient resources) to audit them all. This should be listed in a “spread sheet” (e.g. an excel spreadsheet).

4.6.3 Considerations in Defining the Audit Universe

The selections of the auditable entities to include in the audit universe are to be based on:

- ▶ The risk profile of the LGA (the more risky areas will be given more attention than others);
- ▶ Human resources and competency of Internal Audit staff (areas that internal audit are not competent will likely to be missed out – but consideration should be given on seeking an expert to join the internal audit team);
- ▶ Discussions with Audit Committee and Management requests (management may request internal auditor to include other audit projects);

Personal intuition of internal auditors (internal auditor may come up with audit projects that are neither fall in the departmental or unit of the LGA, but they feel that they need to include in their audit universe).



An audit universe may not necessarily cover every unit within the LGA; some units/processes are just too small, low risk, or technically complex to be considered for regular internal audit reviews.

Source: Moeller (2009)

4.7 Conducting Risk Assessment to Prioritize Auditable Areas

The next step after defining the audit universe is to prioritize the auditable entities. This is done by conducting a risk assessment so as to rank the auditable entities (i.e. from the most risky to less).

4.7.1 Formulating the Common Risk Factors

Due to the diverse nature of the auditable entities in the audit universe, it is necessary to select appropriate common criteria (i.e. risk factors) that will facilitate the comparison.

A risk factor, as defined earlier, these are conditions that can influence the frequency and/or magnitude and ultimately, the business impact of an event/scenarios. In a simple language, it is a combination of conditions and/or obstacles that the LGA faces in achieving its objectives, and used as criteria to weigh each auditable area so as to facilitate comparison/ranking.

A study by IIA's GAIN (2009) reported the following risk factors to be used by auditors around the world (see Figure 4).

Figure 4: Example of Risk Factors used by Internal Audit Units across the World

Factor	Government	Audit Staff: 1 to 5	Universe
Degree of Financial Materiality	100%	84%	92%
Complexity of Activities	94%	79%	87%
Control Environment	94%	79%	89%
Reputational Sensitivity	92%	53%	69%
Inherent Risk	92%	72%	84%
Extent of Change	89%	84%	89%
Confidence in Mgmt	83%	61%	68%
Fraud Potential	81%	65%	81%
Time Since Last Audit	78%	67%	80%
Volume of Transactions	78%	65%	70%
Degree of Automation	72%	60%	72%

Source: IIA GAIN 2009 Benchmark Study

For example, the Internal Audit Manual for LGAs (2013) has given the following risk factors:

- i. Financial Impact (i.e. Materiality):
 - ▶ The overall annual budget for unit, from any source (e.g. from own or government and other funding sources).
 - ▶ If there was misuse of funds or something went wrong financially, what would be the impact to the organization financial perspective?
- iii. Criticality of the Auditable Unit (i.e. Impact)
 - ▶ This refers to the criticality of the unit/process to the proper functioning of the LGA. What would be the impact of the unit not providing its services to the LGA?
- iv. Public and/or Political Sensitivity (i.e. Visibility)
 - ▶ This refers to the sensitivity of the unit to public/press exposure of any internal issues, and the level of public embarrassment that could be caused to the organization as a whole.
 - ▶ It is important to note that the more the common risk factor the lengthier the risk assessment becomes. So it is wise to select about 3 or 4 very critical factors.

4.7.2 Scoring and Ranking the Common Risk Factors

Scoring and ranking is most challenging step in the planning process. One of the approaches in scoring the common risk factors is to use a matrix of combined common risk factors as used by Griffith (2005), where all the common risk factors are plotted in a single matrix as in Figure 5 below.

In this approach, each of auditable entities in the audit universe is given a score depending on the likelihood and impact of an event happening (in a grouped common risk factors i.e. financial, criticality and interest from stakeholders).

Figure 5: Risk Assessment Matrix (Adopted from Griffith, 2005)

		Once every		
Likelihood of Occurrence	1 to 2	4	7	9
	2 to 10	2	5	8
	10 years or less	1	3	6
		Tshs. 10 million [or significant goals not met, or minimum interest from stakeholder]	Tshs. 10–50 million [or major regulatory breach or local stakeholder/media]	Tshs. 50 and above [or Critical regulatory breach or national stakeholder/media]
		Impact on Organisation		

The most significant auditable entities are those in the red zone i.e. boxes 6 to 9. (Box 6 is yellow but is particularly important due to the much attention from the media and stakeholders). These are followed by those in the yellow zone and later in the green zone.

Example:

Table 2: Illustration of Risk Assessment based on Risk Matrix

S/No.	Auditable entity	Score
1	Payroll	6
2	Procurement process	9
3	Human resources	3
4	Revenue collection	7
5	Travel expenses	5
6	Etc.	
7	Etc.	

Another approach is as exhibited in the LGA's Internal Audit Manual (2013) where a scale is given for each risk factor and their combined likelihood of happening.

Financial materiality	Points
Audit area over Tshs. 100 million?	3
Audit area is Tshs 10 million to Tshs. 99.9million?	2
Audit area is less than Tshs. 10?	1

Impact on operations	Points
Significant impact on core LGA operations	3
Significant impact on specific program, moderate impact on core LGA operations	2
Negligible impact on specific program or core LGA operations	1

Public sensitivity	Points
Significant impact on core LGA operations	3
Significant impact on specific program, moderate impact on core LGA operations	2
Negligible impact on specific program or core LGA operations	1

Probability of risk happening	Points
High probability of significant issues	3
Moderate probability of significant issues and high probability of improvement needed	2
Low probability of significant issues and moderate to low probability of improvement needed	1

From the score column, a comparison is made so that the following key is followed.

Table 3: Illustration of Scores and Colour of Common Risk Factors

Risk score (Impact x Likelihood)	Colour	Meaning and Response Required
1–2	Green	Low audit concern
3–5	Yellow	Moderate audit concern
6–9	Red	Very serious audit concern

Then, like in the previous approach, each of the auditable entities in the audit universe is given a score on each of the common risk factor.

Example:

Table 4: Illustration of Risk Assessment of based on Common Risk Factors

S/ N°	Auditable entity	Risk factors			Average	Probability	Score
		Materiality	Impact	Sensitivity			
1	Payroll	2	3	1	2	2	4
2	Procurement process	3	2	3	2.7	3	8
3	Human resources	2	3	1	2	1	2
4	Revenue collection	3	2	2	2.3	2	4.7
5	Travel expenses	1	1	2	1.3	1	1.3
6	Etc.						
7	Etc.						

4.8 Formulating Strategic Audit Plan

Depending on the amount of the auditable entities in the audit universe, the audit coverage may be spread to cover 3 to 5 five years.

And based on the scoring from the risk assessment, the auditable entities are ranked to determine priority, such that:

- ▶ Higher risk audit entities would be audited more frequently or some may have continuous audits scheduled in intervening years;
- ▶ Medium ranked audit entities would be audited at least once on a three year audit cycle;
- ▶ Low risk audit entities would not be audited but would be continued to be assessed for higher risk and hence the necessity for audit.

Example:

Table 5: Illustration of 3 Years Audit Schedule

S/No.	Auditable entity	Score in Risk Assessment	Year 1	Year 2	Year 3
1	Payroll	4	x		
2	Procurement process	8	x	X	x
3	Human resources	2			
4	Revenue collection	4.7		X	
5	Travel expenses	1.3			
6	Etc.				
7	Etc.				

4.9 Formulating Annual Audit Plan

The annual plan will deduce the list of auditable entities from the current year of the strategic plan; it will now list those high risk areas that are targeted for audit cover during the next 12 months.

The formulation of annual audit plan is not different from the strategic plan since the risk assessment approach is still the same.

The only point to note is whether the LGA internal audit unit did prepare the strategic plan. If there is a strategic plan as in the above, then the annual plan of auditable entities is to be drawn from one of the years in the 3 years plan, and then broken down into quarterly or monthly audit schedules. But if there is no strategic plan then auditors have to start from scratch by conducting the risk assessment of the auditable entities and later spread them into monthly or quarterly audit schedules.

Example:

From the previous 3 years plan, we take year 1 e.g. 2015 and break it into quarterly schedules

Table 6: Illustration of an Annual Internal Audit Schedule broken into Quarterly Plans

S/No.	Auditable entity	Score in Risk Assessment	Estimated Audit days	Year 1 (e.g. 2015)			
				Quarter 1	Quarter 2	Quarter 3	Quarter 4
1	Payroll	4	5		x		
2	Procurement process	8	10	x			
3	Etc.						
4	Etc.						

4.10 Estimating the Audit Resources

Audit plans, especially annual plans must be resourced. The most appropriate starting point is the estimation of available audit days to cover the planned audit projects in a financial year.

Consideration should be made on number of auditors and the scope of coverage as given in the example below:

- i. Start with the available number of internal audit staff;
- ii. Multiply that number with the available work hours in the year;
- iii. Reduce these days by allowance for vacation, sick leave, employee training, staff meeting etc.
- iv. The remaining is the available audit days, which are allotted to specific auditable entities according to the internal auditor's judgement and past experience.

4.11 Reviews with Management

It is important that audit plans are reviewed by the management so that to get their inputs and approval. This also in one way or another makes the management involved in the development of audit plans hence include their area of priority while at the same time understanding the resources need by the internal audit unit.

The reviews could be in a form of meetings with operating managers (i.e. Heads of Departments). Copies of audit plans are distribute in advance to members of the management. After reviews with operating management the audit plans should be adjusted to accommodate inputs from management.

The next level of reviews should be a discussion with the Audit Committee and later to the Executive Director.

4.12 Review Questions

- v. Define the following terms: risk, risk factor and audit universe.
- vi. Explain the justification of risk-based audit planning.
- vii. What are the different approaches to defining the audit universe?
- viii. Using one of the approaches mentioned above, list down at least 20 auditable entities in your LGA and conduct a risk assessment of the entities using a common risk factors approach.

Session 5

5 Planning The Audit Engagement

5.1 Introduction

Performance standard 2200 states that “internal auditors must develop and document a plan for each engagement, including the scope, objectives, and timing and resource allocations”.

Without adequate planning, the likelihood of missing relevant control weaknesses or encountering engagement-related problems increases considerably.

This session discusses the audit engagement planning process, taking the planning process the annual plan to lower implementation levels.

5.2 Learning Objectives

The main objective of the session is to enable participants understand the key steps in planning individual audit assignments thus enable them practically plan their engagements at their workplaces.

Specifically, at the end of this session the participants will be able to:

- ▶ Define and set audit objectives and scope of their audit engagements;
- ▶ Explain the purpose for planning and setting resources for audit engagements;
- ▶ Conduct entrance meetings;
- ▶ Carry out preliminary surveys prior to audit fieldwork;
- ▶ Prepare audit programs.

5.3 Definitions

Audit objective:

Audit objectives represent the high-level goals and anticipated accomplishments of the review and address controls and risks associated with the client's activity.

Audit program:

An audit program is a document that consists of a detailed plan of the work to be performed and includes the steps required to achieve audit objectives.

5.4 Purpose of Planning the Engagement

Engagement planning is performed to provide a means for understanding:

- ▶ The objectives of the auditee unit;
- ▶ The methods used to achieve those objectives;
- ▶ The risks associated with those methods; and

- ▶ The controls implemented by management to mitigate those risks and provide assurance of achieving the desired objectives.

The understanding of the auditee unit enables the auditor:

- ▶ To identify/formulate significant audit objectives; and
- ▶ To prepare an audit program that tests significant controls and operations.

5.5 Team Appointment and Preliminary Meetings

5.5.1 Team Appointment

Sawyer's (2012) explains that the most important resource to successful audit engagement is the knowledge, skills, and experience of the audit team. In this case care should be taken in selecting internal auditors to assign to the engagement.

In appointing the audit team, the head of audit should consider the nature and complexity of the engagement; however a balance should be obtained to create a learning opportunity for new and inexperienced auditors.

Outsourcing possibilities, or hire of experts or guest auditor, should be considered where the internal audit unit is faced with an assignment that is beyond its current expertise.

! In appointing an expert or guest auditor, it is important to consider the independence of that expert. It is crucial that a subject-matter expert is independent of the area to be audited.

5.5.2 Preliminary Team Meeting and In-Office Review

Internal Auditing staff assigned to the engagement should meet to discuss the preliminary objectives/information regarding the activity to be audited. If possible, the head of internal audit unit should attend the meeting.

The nature of the preliminary meeting depends on the engagement. For example, several preliminary issues/information may be discussed during a meeting for an activity that has never been audited. If the area has been audited before and is compliance oriented there may be no need for such a meeting.

At this meeting the team will discuss a number of issues relating to the assignment including:

- ▶ The unit to be audited, its objectives and potential issues/risks;
- ▶ Policies, laws and any criteria existing for the unit;
- ▶ Past audit reports and issues from the CAG reports;
- ▶ Setting tentative audit objectives.

At this initial stages, the audit team will also need to review a number of documents from previous audit files (if any), or search for any literature related to the audit engagement.

5.5.3 Client Notification

The Head of Audit unit or auditor in charge should contact the auditee and inform them that an audit of their department/unit has been scheduled.

Usually, such notification is by an engagement letter written at least 5 working days before the commencement of the audit. The engagement letter should inform the auditee the purpose of audit,

date of the entrance conference, staff that are to be present, the type of information/ documents that they should prepare (if known).

However, auditees of certain engagements, such as surprise cash counts and investigations, are not sent notifications.

5.5.4 Holding and Entrance Conference

Entrance conferences are conducted with Internal Auditing staff and management of the activity being audited in order to discuss the audit process and to obtain information from the management of the activity. Certain engagements, such as surprise cash counts and investigations do not require entrance conferences.

Noted below are standard agenda items that are discussed at entrance conferences:

- ▶ Planned engagement objectives and scope of work;
- ▶ The timing of engagement work;
- ▶ Internal auditors assigned to the engagement;
- ▶ The process of communicating throughout the engagement, including the methods, time frames, and individuals who will be responsible;
- ▶ Conditions and operations of the activity being reviewed, including recent changes in management or major systems;
- ▶ Concerns or any requests of management;
- ▶ Matters of particular interest or concern to the internal auditor;
- ▶ Description of the internal auditing activity's reporting procedures and follow up process.

It is essential that a rapport is created for participative audit. Auditee staff should be made to feel that auditors are there to provide them with assurance on the achievement of their unit's objectives, as opposed to the idea of catching their mistakes.

Auditees should be given an opportunity to give their inputs on what they think are key areas that auditors should give more attention. They should also be informed that their audit reports will not be issued before they give their comments.

5.6 Conducting a Preliminary Survey

After the entrance conference with the unit management, the audit staff will conduct a preliminary survey of the unit to obtain an understanding of the activity to be audited and to identify risks associated with the activity.

Where the LGA has a comprehensive risk register, the audit staff may use it as a source to identify risks that are related to the audited activity.

During the survey find out:

- ▶ Who does what, why it is done, where it is done, how it is done?
- ▶ How it is administered?
- ▶ How much does it cost?
- ▶ What are its objectives, goals, and standards?
- ▶ What are the risks to the operation/activity?
- ▶ What controls have been devised to see that objectives are met and risks are minimized?

The auditors may conduct the preliminary survey by:

- ▶ Conducting a physical tour of the offices with the auditee manager (if it is out of their normal area of work);
- ▶ Review of legally required documents (e.g. law and regulations, policies etc.);
- ▶ Study of the financial profile of the activity;
- ▶ Interviews on operating instructions;
- ▶ Problem areas and risks assessment (use a risk register if any).

Alternatively, the auditor may structure their preliminary survey on the COSO (2013) – Integrated Internal Control Framework. In this case they will gather information on all the components of internal control as follows:

i. Control environment

- ▶ Includes, the volume of activity, objectives, organization, locations and processes to be reviewed, for the period to be covered by the planned audit;
- ▶ Policies, plans, procedures, laws, regulations, and contracts, which could have a significant impact on operations and reports of the unit to be audited; and
- ▶ Managerial tone and operating style and assignments of responsibility.

ii. Risk assessment

- ▶ The risks which the unit is exposed to and are being managed by the unit, location or process and the results of any recent risk and control self-assessments. The focus should be on the “inherent risks” not residual risks.
- ▶ The risk register, if present, will be a valuable source of these risks. However, internal auditors must judge whether this register is comprehensive enough for their purpose.

iv. Control activities

- ▶ The overall system of internal controls governing the unit, location or process (though not at a detailed level, this will be examined during the field work/audit).

v. Monitoring

- ▶ The results of past internal and external audits, or internal reviews carried out;
- ▶ The results (current, recent trends) of performance indicators where available for the unit, location or process, or particular problems or events which indicate vulnerabilities in the policies, processes or systems to be audited.

vi. Information and communications

- ▶ The information systems being used to support the unit, location or process and whether it would be appropriate to include the use of computer assisted audit tools and other data analysis techniques;
- ▶ Reports and communication on the unit, location or process to be audited.

5.7 Setting Audit Objectives

As defined in the definitions box, audit objectives are specific statements about what the audit engagement wants to achieve.

The audit objectives must be clearly stated, specific, capable of being evaluated by the available audit evidence, sufficient to render an audit opinion and likely to result in a useful audit report.

Performance Standard 2210 stipulates that audit objectives should reflect the results of a preliminary survey as explained in the previous section.

Specifically, the following key issues should guide in the formulation of audit objectives:

- ▶ Objectives and goals of the unit to be audited;
- ▶ The risks of the activity;
- ▶ Possible errors, fraud, non-compliance issues and other exposures facing the unit to be audited.

Example:

In a payroll audit engagement, engagement objective may be to ascertain whether:

- i. Comprehensive policies and procedures addressing payroll activities have been developed and documented;
- ii. The LGA is in compliance with established policies and regulatory requirements for payroll and taxation;
- iii. Access to payroll records is limited to authorized personnel;
- iv. Wages and taxes are authorized and accurately recorded;
- v. Payrolls are properly prepared, approved, and recorded; and,
- vi. Recorded balances are regularly substantiated and reviewed.

It should be noted that most of the clues on how to set audit objectives are obtained during the in-office review and preliminary survey.

In these stages, internal auditors are likely to come up with questions on:

- ▶ What are the operating objectives of this activity?
- ▶ What are the policies, laws and regulations that should be applied here? Are they complied with?
- ▶ What are the risks relating to non-compliance, fraud, errors, reporting, injury etc.? And what are the mitigating controls against those risks?
- ▶ Are these controls effective?

5.8 Preparing Engagement Work Program

Preparation of the Audit Program Guide concludes the preliminary review phase. The audit program outlines the fieldwork necessary to achieve the audit objectives. The purpose of an audit program is to show the procedures to follow during the audit, so that the audit can reach its specific objectives.

5.8.1 Advantages of a well Prepared Audit Program

As defined above, an audit program consists of a detailed plan of the work to be performed and includes the steps required to achieve audit objectives. A well-structured audit program has the following advantages:

- ▶ Provides an outline of the work to be performed and encourages a thorough understanding of the audited unit;
- ▶ Furnishes evidence that the work is adequately planned;
- ▶ Assists in controlling work and assigning responsibility to audit staff in the team;

- ▶ Aids in reviewing the progress and quality of the audit;
- ▶ Provides a record that can be reviewed and approved by the head of internal audit unit before performance of work, thereby contributing to assignment supervision; and
- ▶ Provides assurances that all appropriate risk areas have received adequate consideration and that important aspects of the audit have not been omitted.

5.8.2 Language and Terms used in Audit Programs

An audit program is usually written in an instructive language with common terms like trace, test, compare etc.

Table 7 give the types of instructions and their meanings as used in audit programs.

Table 7: Instructions used in Audit Programs and their Meaning

Audit program instruction	Meaning of the procedure
Verification	Verification is the confirmation of things such as: records, statements, and documents, compliance with laws and regulations, effectiveness of internal controls. The purpose of verification is to establish the accuracy, reliability or validity of something.
Compare	Identify similar and/or different characteristics of information from two or more sources. Types of comparison include: comparison of current operations with past or similar operations, with written policies and procedures, with laws or regulations, or with other reasonable criteria.
Examine	To look over something very carefully, such as a document, in order to detect errors or irregularities. Example: examine a document to verify that it has been executed by authorised persons.
Re-compute	To check mathematical computations performed by others.
Confirm	Obtain information from an independent source (third party i.e. bank statements) for the purpose of verifying information.
Reconcile	This is the process of matching two independent sets of records in order to show mathematically, with the use of supporting documentation, that the difference between the two records is justified. For example, the reconciliation of a bank statement's balance at the end of the month with the book balance or the reconciliation of the suppliers Debtor Statement with the book balances.
Vouch	Verify recorded transactions or amounts by examining supporting documents. In vouching, the direction of testing is from the recorded item to supporting documentation. The purpose for vouching is to verify that recorded transactions represent actual transactions.
Trace	Tracing procedures begin with the original documents and are followed through the processing cycles into summary accounting records. In tracing, the direction of testing is from supporting documentation to the recorded item. The purpose of tracing is to verify that all actual transactions have been recorded.
Observation	Observation is auditors seeing with a purpose, making mental notes and using judgement to measure what they see against standards in their minds.

Audit program instruction	Meaning of the procedure
Inquiry	<p>Auditors perform interviews with the auditee and related parties throughout the audit.</p> <p>Good oral communication skills and listening ability on the part of the auditor assist in getting accurate and meaningful information from the interviewee are essential.</p> <p>Auditors should use open-ended questions when possible. Depending on the type of information received in an interview, it may need to be confirmed through documentation communication.</p>
Analysis	<p>Analysis is the separation of an entity for the purpose of studying the individual parts of data. The elements of the entity can be isolated, identified, quantified, and measured.</p> <p>The quantification may require the auditor to perform detailed calculations and computations.</p> <p>Furthermore, the auditor can document ratios and trends, make comparisons and isolate unusual transactions or conditions.</p>

5.8.3 Linking Audit Objectives to Audit Procedures

When preparing an audit program it is important to focus on steps (audit procedures) that will lead to the achievement of audit objectives. This is only possible if each audit objective is thought separately and specific procedures are developed in that regard.

Example:

Table 8: Extract of a Payroll Audit Program Linking Audit Objective and Audit Procedures

Audit objective:	To ensure all new hires were legitimate, properly authorised and accurately recorded in a timely manner.
-------------------------	--

S/No.	Audit procedure	W/P Ref	Initial
1	Review new hire report and randomly select 10 new hires.		
2	Note important information on a spreadsheet (i.e. name, employee #, pay rate).		
3	Trace information to supporting documentation in the employee files and online system to ensure accuracy.		
4	<p>Test the following attributes:</p> <ul style="list-style-type: none"> i. New hire is actually an employee (exists in LGA directory, email system, etc.). ii. Payroll added new hire to payroll register in a timely manner. iii. Pay rate information is consistent with supporting documentation. iv. Employee attended orientation in a timely manner. v. Senior Payroll/HR lead initialled form indicating review of entry. vi. A complete background check was performed on the employee. vii. Employee signed security policy acknowledgment form. 		

5.9 Review Questions

- i. Define the terms audit objective and audit program.
- ii. What are the purposes of planning an audit engagement?
- iii. What are the main considerations on appointing an audit team?
- iv. What are the possible agendas for an entrance conference?
- v. Using the COSO (2013) Internal Control – Integrated Framework, explain the various issues that internal auditors need to find out during a preliminary review.
- vii. Pose as an audit team which is appointed to audit a procurement process:
 - ▶ Set three audit objectives that you want your audit team to accomplish.
 - ▶ On each of the above objectives, design appropriate test/audit procedures that will lead to the achievement of each of the objectives.
 - ▶ Prepare an audit program based on the above audit objectives and audit program.

Session 6

6 Conducting an Audit Engagement

6.1 Introduction

The process of implementing the audit program involves collecting, analysing, interpreting and documenting information on matters related to the audit objectives and scope. The objective of an audit is to obtain sufficient, competent, relevant, and useful information to provide a sound basis for audit findings and recommendations.

This session presents a number of key issues in conducting an audit so as to obtain audit evidence and reach an appropriate audit conclusion.

6.2 Learning Objectives

By the end of this session the participants should be able to:

- ▶ Define audit evidence;
- ▶ Explain the qualities of an audit evidence;
- ▶ Carry out different techniques for collecting audit evidence;
- ▶ Record an audit finding in a five-attribute format; and
- ▶ Describe how to maintain audit working papers.

6.3 Definitions

The following definitions are applicable in this session:

Audit evidence:

Audit evidence refers to all the information used by the auditor in arriving at the audit opinions, conclusions and recommendations.

Working papers:

Audit working papers are the records kept by the auditor of the audit procedures applied, the tests performed, the information obtained and the pertinent conclusions reached in the audit engagement.

6.4 Qualities of Audit Evidence

Performance standard 2300 requires internal auditors to identify, analyse, evaluate, and document sufficient information to achieve the engagement's objectives. Evidence may be categorized as physical, documentary, testimonial and analytical.

To qualify into audit evidence, the information collected by internal auditors should have the following qualities:

i. Sufficient

- ▶ Sufficient information is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor.
- ▶ There should be enough of it to support the auditor's findings.
- ▶ In determining the sufficiency of evidence, it may be helpful to ask such questions as:
 - Is there enough evidence to persuade a reasonable person of the validity of the findings?
 - When should appropriate statistical sampling methods be used to establish sufficiency?

ii. Competent

- ▶ Competent information is reliable and the best attainable through the use of appropriate engagement techniques such as statistical sampling and analytical audit procedures.
- ▶ Information is more competent if it is:
 - obtained from an independent source,
 - corroborated by other information,
 - obtained directly by the auditor, such as through personal observation,
 - documented, and
 - original document rather than a copy.

iii. Relevant

- ▶ Relevant information supports engagement observations and recommendations and is consistent with the objectives for the engagement.
- ▶ Relevant information should have a logical, sensible relationship with the associated audit finding.

iv. Useful

- ▶ Useful information helps the LGA meet its goals.

Evidence collected by internal auditor should possess all of these qualities.

For example:

- ▶ It is not enough to merely interview staff members without corroborating the information obtained with that from other sources.
- ▶ Sample sizes should be representative so that conclusions reached may be validly extended to the rest of the population.

6.5 Testing Procedures, Strategies and Techniques

Testing is the art of securing suitable evidence to support an audit. The next discussion is based on Pickett's (2005) presentation of testing process, testing strategies and techniques, as presented below.

6.5.1 Testing Process

The testing process may be noted in the following series of events:

- i. An auditor defines the test objective (see audit objective setting and audit program);
- ii. Then, he/she defines the testing strategies (see below i.e. compliance, substantive etc.);
- iii. The auditor formulates a series of audit testing programs (see audit/engagement work program);
- iv. The audit, then perform the tests (see testing techniques below);
- v. The auditor documents the evidence, interpret the results.

6.5.2 Testing Strategies

There are three types of tests i.e. walkthrough, compliance, and substantive:

- i. Walkthrough
 - ▶ This involves taking a small sample of items that are traced throughout the system (audit trail) to make sure that the auditor understands the system.
 - ▶ Usually this is used by the auditors when ascertaining the system, hence may lead to further tests.
- ii. Compliance
 - ▶ These are tests done when auditors want to establish whether key controls are being adhered to.
 - ▶ It uncovers non-compliance or if controls are not implemented as intended.
- iii. Substantive
 - ▶ These are tests to determine whether control objectives are being achieved.
 - ▶ They are usually done after compliance tests – to determine the effect of non-compliance.

6.5.3 Testing Techniques

Testing techniques are ways in which auditors gather evidence to support testing objectives. There is no limit to such testing as long as it makes sense and will lead to results. The following are examples of techniques:

- i. Observation

This is when an audit uses the senses to assess certain activities; for example, observing inventory stock taking to assess whether employees are following instructions.
- ii. Confirmation

This involves receipt of a written or oral response from an independent third party, for example confirmations of bank balances.
- iii. Inquiries

Inquiries of client could be written based on oral information from the client. Examples of this technique include internal control questionnaires or asking employees if certain procedures are being followed.

iv. Re-performance

Re-performance or mechanical accuracy involves rechecking computations for arithmetic accuracy or re-performing accounting routines.

v. vouching

Vouching involves agreeing amounts of two or more different documents, for example, agreeing amounts on purchase orders to supplier invoices and receiving reports.

vi. Physical examination

This is an inspection or counting by the auditor of tangible assets e.g., cash, inventory, etc.

vii. Scrutiny or scanning

Scrutiny is a searching review of data in order to locate significant items that require further investigation, e.g., scrutiny of the general ledger for unusual or unexpectedly high or low values, etc.

viii. inspection

Inspection is the examination of documents other than source documents for a transaction, e.g., inspection of lease agreements, or legal advisor's letter reporting on a land purchase.

As pointed out earlier, the choice and type of testing techniques are limited only by auditor's imagination. There are other techniques that an auditor can use to come up with a finding that are not even listed in this section. In this regard, auditors are required to be both innovative and adoptive to the circumstances surrounding the engagement and the achievement of the audit objectives.

6.6 Recognizing and Recording of Audit Finding

6.6.1 What is a Finding?

When testing or gathering evidence, the auditor may find errors or situations that are not matching to the required or expected standards or criteria. This is what is termed as an audit finding or observation. All significant audit findings should be reported to management for corrective action.

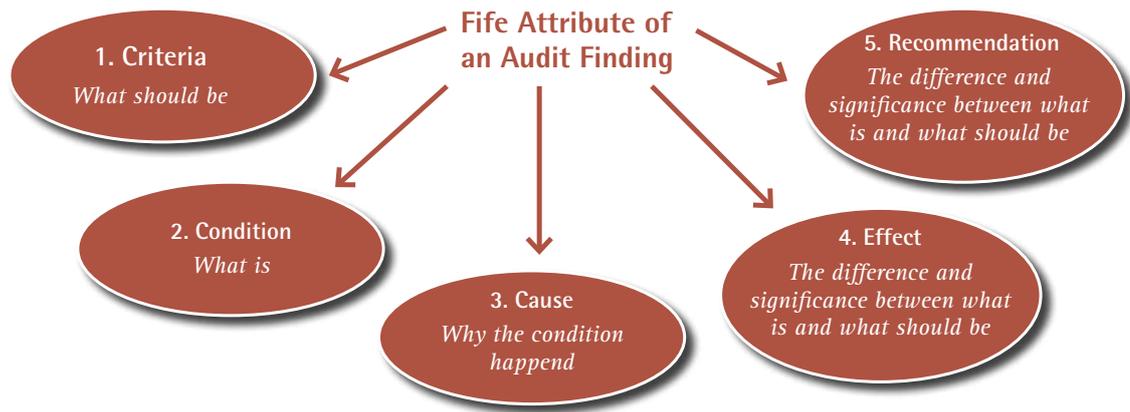
A reportable finding is a significant condition which:

- ▶ Warrants the attention of management;
- ▶ Is documented by facts, not opinions, and by evidence that is sufficient, competent and relevant;
- ▶ Is objectively developed without bias or preconceived ideas;
- ▶ Is relevant to the issue involved; and
- ▶ Is convincing enough to compel action to correct the defective condition.

6.6.2 Five Attribute of Audit Finding

Audit findings should contain the five attributes/elements which are criteria, condition, cause effect and recommendation as given in Figure 7 below and explained in the following sections:

Figure 6: Five Attributes of an Audit Finding (Source: LGA Internal Audit Manual, 2013)



i. Criteria

- ▶ The standards, measures, or expectations used in making an evaluation or verification.
- ▶ What should exist?
- ▶ Written requirements (laws, regulations, instructions, manuals, directives, etc.);
- ▶ Overall objectives of LGA;
- ▶ Auditor’s experience;
- ▶ Common Sense, Prudent Business Practice;
- ▶ Independent opinion of experts;
- ▶ Generally accepted standards.

The criteria is usually established during the preliminary survey or planning stage of an audit.

ii. Condition

- ▶ The factual evidence that the auditor found during the audit which shows what actually exists.
- ▶ What does exist?
- ▶ What is defective?
- ▶ What is deficient?
- ▶ What is in error?
- ▶ Is it isolated or widespread?
- ▶ This is usually the difference (a deviation) between the criteria and the actual situation that the auditor finds.

iii. Effect/Impact/Risk

- ▶ The risk or exposure to the organization being audited because the condition is not the same as the criteria.
- ▶ Difference between criteria & condition;
- ▶ Financial loss;
- ▶ Uneconomical or inefficient use of resources;
- ▶ Loss of potential income;

- ▶ Violation of law;
- ▶ Ineffectiveness (job not being done as well as it could be);
- ▶ Funds improperly spent;
- ▶ Information, records or reports are not useful, meaningful, or accurate;
- ▶ Inadequate control or loss of control over resources;
- ▶ Job not being done properly;
- ▶ Lowered morale.

iv. Cause

- ▶ The reason for the difference between the criteria and condition (Why does the difference exist?)
- ▶ Lack of qualifications to do the job;
- ▶ Management not doing its job;
- ▶ Lack of training;
- ▶ Lack of communication;
- ▶ Negligence or carelessness;
- ▶ Instructions are faulty;
- ▶ Lack of resources;
- ▶ Dishonesty;
- ▶ Insufficient effort or interest;
- ▶ Unwillingness to change;
- ▶ Faulty or ineffective organizational arrangement.
- ▶ It is important for auditors to investigate the cause of deviations. This is because recommendations for corrective efforts are addressed on the cause of the problem.

v. Recommendation

- ▶ The action necessary to bring the condition in line with the criteria.
- ▶ Should focus to correct the “cause” of the deviation;
- ▶ Should be specific and helpful;
- ▶ Should pinpoint accountability and responsibility;
- ▶ Should not supersede management’s responsibility to manage and addressed to officials with power to make a change.

In most internal audit reports, two elements that are missing most frequently are “cause and effect”. When these elements are missing - the finding is usually not convincing. Also, without the cause - you cannot make a good recommendation.

Auditors when come across what they believe to be a significant audit finding they usually record such a finding in a special form which may be designed to capture the five attributes of the finding.

Figure 7: Example of Form to Record an Audit Finding
 (Source: LGA Internal Audit Manual, 2013)

LOGO PMO-RALG LGA X	W/P Ref _____
Client: _____ Title: Five Attribute Sheet _____ Period _____ Subject _____	Prepared by: _____ Prepared on: _____ Reviewed by: _____ Reviewed on: _____
Audit Objective:	
Condition:	
Same finding disclosed in the last audit?: Yes ___ No ___	
Criteria:	
Test Made:	Refer from
Cause (s):	
Risk (s):	
Recommendation (s):	
Comments by Client Personnel:	

6.7 Maintaining Audit Working Papers

6.7.1 What are Audit Working Papers?

As define in the definition box, audit working papers are the records kept by the auditor of the audit procedures applied, the tests performed, the information obtained and the pertinent conclusions reached in the audit engagement.

Internal auditors are required to keep audit working papers which contain all information of the work done and that support the audit report.

6.7.2 Objectives of Audit Working Papers

Audit working papers serve the following objectives:

- ▶ Provides a historical record of the information collected during the conduct of audits;
- ▶ Provides a record of the audit tasks performed;
- ▶ Identifies audit objectives and methods chosen as a basis for planning future audits and for review purposes;
- ▶ Allows an audit supervisor or manager to make an interim review of what has been done during the audit to date;
- ▶ Allows an audit supervisor or manager to carry out final assessment of the validity of draft audit conclusions before they are expressed as audit findings;
- ▶ Provides support for audit findings and evidence of compliance with the internal audit standards;
- ▶ Establishes a record for the purposes of peer review;
- ▶ Provides a framework for further review in cases where management disagrees with audit findings and the audit methods and conclusions have to be reassessed;
- ▶ Provides a framework of control whereby delegated work is monitored.

6.7.3 Principles of Maintaining Audit Working Papers

In order to prepare and maintain audit working papers of good quality, internal auditors should observe the following principles:

i. Consistency and Standardization

- ▶ When carrying out audits, internal auditors should use consistent writing/reporting methods.
- ▶ Consistency is achieved by using the standard formats appearing in the Internal Audit Manual (see LGA Internal Audit Manual on working papers).
- ▶ Completing the recommended formats will make documentation easier to understand and review.
- ▶ For instance, if an auditor takes over a work that has been started by another auditor, the use of standardized formats will promote continuity. However, practical experience may dictate the need for amendment of standard formats. Moreover, the auditor could use additional formats as necessary.

ii. Accuracy and Timeliness

- ▶ Documentation should accurately reflect the tests planned, the tests carried out and the result of these tests.
- ▶ There should also be documents that show the timing of the work carried out.

iii. Clarity and Conciseness

- ▶ The aim is to provide working papers that will make it easy to understand the way the audit was carried out.
- ▶ For this, the working papers should be well organized and cross-referenced with clear and concise language and structure.
- ▶ The information recorded should be sufficient for the purposes of subsequent review by someone other than the responsible auditor.

iv. Completeness

- ▶ The audit papers should be complete in the sense of covering the whole audit, the tests carried out, the meetings held, the queries raised, management responses and the draft conclusions reached.

v. Authorship and Review

- ▶ Audit papers should reveal who carried out each piece of work. In addition, working papers should be reviewed by the Head of internal audit or auditor in charge.
- ▶ Information regarding the identity of reviewers and their instructions/advice should be documented.

vi. Confidentiality

- ▶ Audit working papers are in principle confidential. The Head of the Internal Audit unit may decide to share audit working papers, only if there is good reason.

6.7.4 Preparation of Working Papers

Audit working papers are prepared throughout the audit process i.e. from planning to field work and reports.

At each stage of the audit, each working paper should be properly identified with such information as:

- ▶ The name of the Public Body/LGA/or unit being examined;
- ▶ The title or description of the content or purpose of the working paper;
- ▶ The period covered by the audit;
- ▶ The preparer and reviewer with respective dates of preparation and review;
- ▶ The index code (see the LGA Internal Audit Manual for indexing and codes)
- ▶ Each working paper should be signed (or initialled) by the preparer and the reviewer.
- ▶ Each working paper should be properly indexed and cross-referenced to aid in organizing and filing.
- ▶ Indexing is done at the front of each paper using combination of letters and whereby if lead schedules are given a letter (see the LGA Internal Audit Manual for indexing and codes).

6.8 Review Questions

- i. Define an audit evidence;
- ii. What are the necessary features of a good audit evidence;

iii. In the following table fill in the appropriate audit technique in the audit procedure describe against it.

Audit procedure	Audit technique
Check that approval required for the payment has been obtained.
Compare amounts on purchase invoices and shipping documents.
Check calculations of payments.
Check calculations are correctly coded
Review insurance policy documents.
Reconcile the gross total to ledger.

- v. Explain the 5 attributes of an audit finding.
- vi. In your group, take a sample of a past audit report in LGA, examine if all the reported findings are in a 5 attribute format. If not re-write the finding.

Session 7

7 Internal Audit Reports

7.1 Introduction

The IIA's on its Performance Standard 2400 requires internal auditors to communicate results of their evaluations while taking into account issues of quality, accuracy, clarity, objectivity, conciseness, constructiveness, completeness and timeliness of such communications.

Reports are the internal auditor's opportunity to get management's complete attention, and a perfect occasion to show management how internal auditors can help.

This session therefore discusses types of internal audit reports and techniques for preparing the reports.

7.2 Learning Objectives

By the end of this session the participants should be able to:

- ▶ Define audit reports;
- ▶ Understand the importance of internal audit reports;
- ▶ Explain the different types of internal audit reports;
- ▶ Understand basic principles in writing effective internal audit reports;
- ▶ Conduct follow- up on the implementation of audit recommendations.

7.3 Definitions

The following definition(s) are essential in this session.

Audit Report

A formal communication of engagement results. This communication includes the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

Source: IIA Standard 2410 – Criteria for Communicating

7.5 Objectives of Internal Audit Reports

Internal audit reports serve three main objectives i.e. to cause management to act and support such action.

However, management will not act before internal auditors have recorded the audit findings, informed and convinced the management on these findings. In summary, within these three objectives as depicted in Figure 8, the report overall serves the following functions:

- ▶ To assure management that risks are well controlled;
- ▶ To alter (inform) them to areas where this is not the case and there are defined risk exposures;
- ▶ To advise (and convince) them on steps to improve risk management strategies;
- ▶ To support action plans prepared by the management.

Figure 8: Objectives of Internal Audit Reports (Source: Lyer, AVANT Garde Academy)



Internal auditors should make sure that their reports are balanced to meet these objectives. Otherwise all the efforts and extensive resources used to conduct an engagement are put to waste.

7.6 Readers of Internal Audit Reports

An internal audit report has many different user groups, each with a specific need. When writing a report, internal auditor should consider such users and make sure that a single report is balanced to meet each group's demands.

In LGA for example, internal audit reports have the following groups of users:

- i. In the audited unit (heads of departments/unit, and process owners):
 - ▶ This group are more interested to see what needs to be done for them to improve and meet their operating objectives and targets.
 - ▶ In this case, they are likely to read all detailed explanation of the finding (on what is wrong) and auditor's recommendations to correct.
- ii. Executives and directors (e.g. DED and Audit Committee, and Council):
 - ▶ More interested on issues of overall governance and effectiveness of risk management.
 - ▶ They need auditor's assurance/opinion if the audited unit will likely meet its objectives as intended by the executive, and whether laws and regulations are complied with.
 - ▶ They are more likely to read the executive summary of the report to get an overview, and go into specific details if the issue is of more relevance.

- iii. External auditors (and external stakeholders e.g. RAS, IAG, PMO-RALG etc.):
 - ▶ They have variety of needs, depending on the issue that moment.
 - ▶ But external auditors mostly likely to use internal audit reports as an assessment tool to see how much reliance they can make on internal auditor, and or take on board some of the internal audit findings.
 - ▶ Other may be more interested in seeing the quality of reporting etc.

7.7 Types of Internal Audit Reports

Internal audit reports can be grouped into the following main types:

- i. Engagement reports
 - ▶ Reports on results of individual assurance audit assignments.
- ii. Periodic reports
 - ▶ Quarterly audit reports summarizing the audit and non-audit activities performed by the internal audit unit over the period (quarter) i.e. It is a summary of the individual engagement reports and other non-audit activities that were undertaken during the quarter.
 - ▶ Annual reporting – summarizes the audit activities or services that were undertaken by the Internal Audit Unit (IAU) during the year. It is prepared based on quarterly reports.
- iv. Special audit reports
 - ▶ Report on special audit arrangements by management and special other investigations.
 - ▶ However, they need to be tailored to suit the specific terms of reference which gave rise to such special assignments (see topic on Fraud Investigation).

7.8 Preparation of Engagement Reports

7.8.1 The Reporting Process

An engagement reports is not just a published document, but is a result of a long process – from planning to implementation of an audit project.

A good report is a result of many steps in the audit process. It starts with a clear understanding of the assignment, the setting of audit objective and respective audit procedures to achieve the audit objectives.

As Pickett (2005) indicates, reporting writing also brings on-board the auditee involvement into formulating corrective action plans.

7.8.2 Elements of an Effective Engagement Report

A Quality Action Team on Reports, as narrated by Lessans and Roslewics (undated) recognised that audit reports were most effectively communicated in reports if the following five key elements are embraced:

i. Solid substance

- ▶ Here auditors should ask themselves if the report have all the 5 attributes of a finding.
- ▶ When drafting the report, auditors should make sure that each audit objective is addressed by an audit finding whose attributes can be readily identified in a five attribute.

Example: Table 9 gives an example of how to structure an audit finding into a five attribute format.

Table 9: Example on How to Write an Audit Finding in a 5 Attribute Format

Attribute	Description
Condition	Statement of the issue: What is the key point you want to communicate to your readers?
	E.g. Capital expenditure of Tshs. 10.8m for Hospital equipment upgrade project were not monitored, and time and budget overruns were not approved.
Criteria	Description of "what should be": What is the policy, standard, principle of business practice are evaluating?
	E.g. Finance policy requires continuous monitoring by the project manager and CEO approval of capital expenditure over Tshs. 2m
Effect/Risk/ Consequence	Explanation of the "Significance or Impact" What is the impact or materiality? What has gone or could go wrong as a result of the condition?
	E.g. The equipment upgrade project was over budget by 30% and the contractors paid no penalties.
Cause	Explanation of "What Allowed the Condition to Occur" What is the root cause of the problem? Why was the condition not detected or corrected?
	E.g. A project manager had not been appointed to manage the hospital equipment upgrade project.
Corrective Action (recommendations)	Description of action necessary to correct the condition
	E.g. The finance manager will require the CEO written approval of all capital expenditure project plans, monthly reports and cost overruns. The CEO will appoint a project manager for each capital expenditure project

ii. Logically sound

- ▶ Does the report make sense, and is it easily readable?
- ▶ The best way to make sound logic is to write in a "deductive manner" i.e. to state conclusions first, and then support them with facts.
- ▶ Such report highlights the points/concerns first, which captures a busy reader's attention and the present the most important details that support it.

iii. Balanced tone

- ▶ Does the report present a tone that is respectful of the auditee?

- ▶ This is an important issue to pay attention to since audit reports usually convey critical information to official who may reluctant to accept criticism or negative message.
- ▶ The best way to do this is to convey the positive information (or good job noteworthy) that is done by the auditee along with negative audit findings.

Example: Use the background section: Give auditee credit where it is due, this will help to soften the mood before going into detailed negative findings.

iv. Printed visual clarity

- ▶ Does the report's appearance guide the busy reader through the logic of material?
- ▶ This aims at providing "instant visual understanding".

Example:

- ▶ Use of tables of contents and an executive summary;
- ▶ Separating the report sections with descriptive sub-captions;
- ▶ Listing information using bullets, numbers, letters or dashes;
- ▶ Using italics or underlying, bold and capitalization for key words and phrases;
- ▶ Incorporating visual aids e.g. charts, tables, graphs and photographs to illustrate key points; and
- ▶ Reserving "white space" on each page to make the text more appealing to read.

v. Good mechanics

- ▶ Do the report's words and sentences clearly and effectively communicate the message?
- ▶ This requires audit team to pay attention to the word in the verbal weaknesses of the report.
- ▶ This is achieved by avoiding to "over-use" certain types of word, including jargons, acronyms, legalese, prepositions, and weak nouns, and check grammar.
- ▶ NB: Please see LGA Internal Audit Manual for the Format of the engagement report.

7.9 Preparation of Periodic Internal Audit Reports

Order No. 14(7) (a) and (b) of the LAFM (2009) require internal auditor to prepare and submit quarterly and annual internal audit report to the accounting officer 15 days after the end of quarter and year respectively.

7.9.1 Quarterly Internal Audit Reports

- ▶ Internal auditors should prepare Quarterly Internal Audit Reports summarizing the audit activities or services that were undertaken by the Internal Audit Unit (IAU) during the quarter.
- ▶ The Council Internal Auditor is responsible for preparation and submission of the quarterly internal audit reports.
- ▶ Quarterly internal audit reports are generally the summary of audit activities that were performed during the quarter by the IAU.
- ▶ They should present the following:
 - Background information covering mandate of the audit function, its key mandates, vision and mission;

- Progress on the implementation of the annual internal audit plan;
- Status of previous quarter's recommendations;
- Audit activities that were performed during the quarter;
- Conclusion and Recommendations.

The report should be accompanied by a submission letter, signed by the HIAU and copied to all relevant organs as per the Order No. 14(7) (a) and (b) of the LAFM (2009).

7.9.2 Annual Internal Audit Reports

- ▶ Annual Internal Audit Report summarizes the audit activities or services that were undertaken by the IAU during the year.
- ▶ It is derived from quarterly internal audit reports. The HIAU is responsible for preparation and submission of the quarterly internal audit reports.
- ▶ Annual internal audit reports should present the following:
 - Background information covering mandate of the audit function, its key mandates, vision and mission;
 - Progress on the implementation of the annual internal audit plan;
 - Status of previous year's recommendations;
 - Audit activities that were performed during the year;
 - Conclusion and Recommendations.

The report should be accompanied by a submission letter, signed by the HIAU and copied to all relevant organs as per the Order No. 14(7) (a) and (b) of the LAFM (2009).

NB: see the LGA Internal Audit Manual for Formats of Quarterly and Annual Internal Audit Reports.

7.10 Review Questions

- i. What is an audit report? Mention types of internal audit reports.
- ii. What are the objectives of preparing internal audit reports?
- iii. What main issues that should be conveyed in quarterly and annual internal audit reports?
- iv. Mention the key elements of an engagement report?
- vi. in your group, take a sample of past internal audit report from you IA unit, review the report to ascertain whether:
 - ▶ It has all the 5 elements of an effective internal audit report.
 - ▶ The findings sections are balanced with the 5 attributes of an internal audit finding.

Session 8

8 Value for Money Audit

8.1 Introduction

Value for money audit (also known as performance audit) has gained popularity in non for profit organisations (NPOs), especially in the public sector due to the apparent difficulties in measuring the performance of these organisations. Unlike the private sector, the focus for NPOs has been on service delivery (not shareholders' value) and the accountability of funds entrusted to them, where stakeholders want the best possible value of money spent by these NPOs on their behalf.

This session presents the basic concepts of value for money, and related audit approach.

8.2 Learning Objectives

This session introduces the participants to key issues on planning and conducting value for money audits. At the end of this session, the participants will be able to:

- ▶ Define value for money or performance audit;
- ▶ Explain the meaning of economy, efficiency and effectiveness in value for money;
- ▶ Set value for money audit objectives and plans to achieve the objectives;
- ▶ Explain the audit procedures in conducting value for money audit procedures.

8.3 Definitions

The following definitions are important in this session:

Value for Money Audit

- ▶ Value for money audit (or performance audit) is the evaluation of how the management of an organisation has put in place arrangements to secure economy, efficiency and effectiveness on the management of resources (financial, human and physical).

Economy

- ▶ The acquisition of inputs in appropriate quality and quantity at the best terms (minimum cost) possible.

Efficiency

- ▶ The maximum output for any given set of inputs or the minimum inputs for any given quantity and quality of goods or service provided.

Effectiveness

- ▶ The extent to which any activity achieves the intended results.

8.4 Concept of Value for Money

8.4.1 Accountability

- ▶ The central issue with value for money in LGAs is that public funds that are directed to local authorities should be put to the best possible use that those entrusted with spending should be held accountable for the economical, efficient and effective management of such funds.
- ▶ One of the sources of debates about accountability in LGAs (and like in other public sector organizations) is due to the fact that information about the aims and results of public spending derives from a variety of disparate sources:

Example:

- ▶ In LGAs the key decisions about funds and allocations are made by central government and the treasury;
- ▶ Spending decisions are implemented by LGAs and by officials in other public services;
- ▶ The main beneficiaries of spending are the general public.
- ▶ From this separation it is often difficult to obtain information of spending and results of such spending of public money which is not disputed by one or other of the groups of LGA stakeholders (e.g. politicians, officials in LGA, auditors, and the public at large).
- ▶ Now part of the drive towards settling these debates and obtaining better Value for Money is the VFM-audit.

8.4.2 VFM Dimensions

In the concept of value for money audit there are two dimensions that auditors need to understand:

i. The Project Dimension:

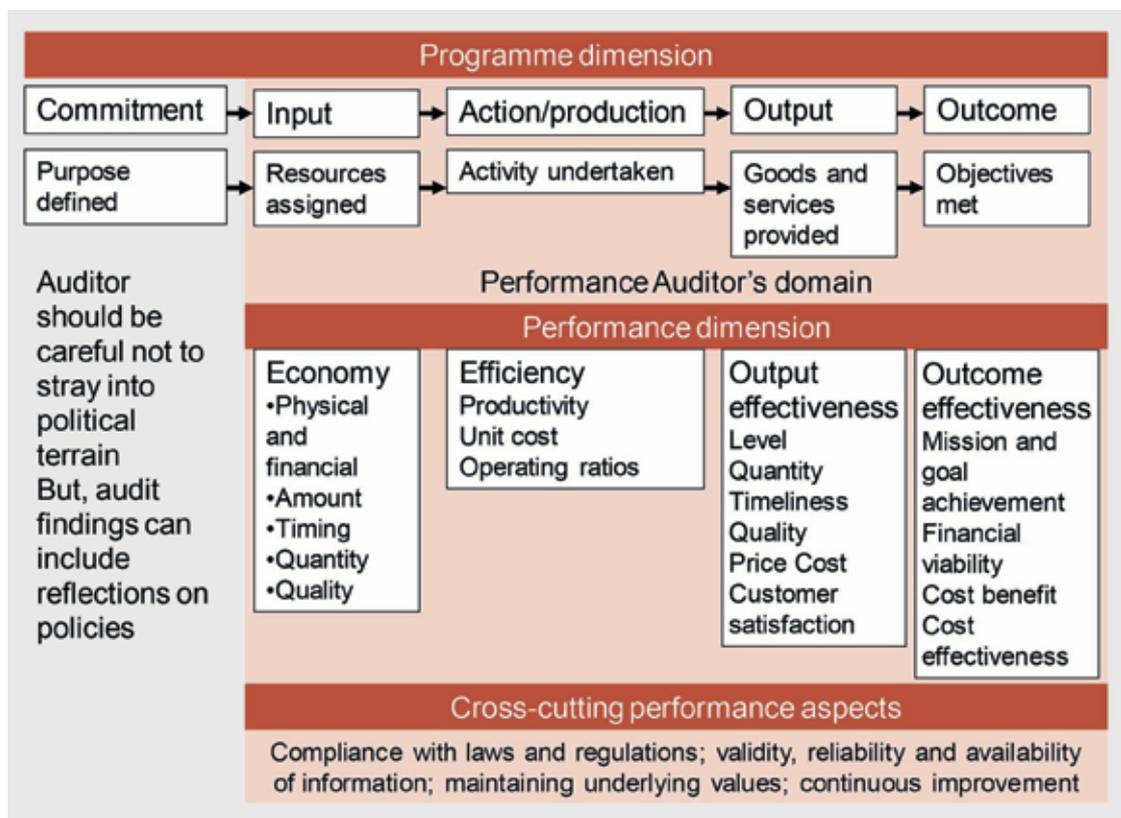
- ▶ This considers performance issues relating to the implementation of the project or system to be audited. The main focus, as indicated in Figure 9, is how the project moves from the **commitment** to the achievement of this **outcome**.
- ▶ The following are the project dimension:
 - Commitment = set the management to set objectives and define the purpose of the project or intervention (i.e. objectives and intentions);
 - Economy = Funds/resources assigned to procure inputs;
 - Efficiency = Inputs are put in the production process by undertaking the planned activity to produced outputs;
 - Effectiveness = outputs (in terms of goods and services) are put into use to cause the outcome and meet the intended objective set at the commitment stage;
 - Cross cutting = compliance with laws and regulations.

ii. The VFM Auditor's Dimension

When a VFM auditor is called in to evaluate the performance of the project or intervention, his/her concern will be aligned with those of the project dimensions but this time in examining how the project management as secured value for money at each component of the VFM chain i.e.:

- ▶ Commitment = what the objectives/intentions of the project (but limits this evaluation as to not question political issues that led to the project);
- ▶ Economy = how the project use their funds to procure inputs (e.g. Staff time, and other resources). The main issues would be on amount, timing, price, quantity and quality of resources procured;
- ▶ Efficiency = how inputs are used to produce outputs (goods & services). Question the input/output in terms of wastage, timeliness, quantity, quality, and customer satisfaction;
- ▶ Effectiveness = how the outputs produce outcomes (i.e. effects on users). Main issue would be are the original intentions/objectives met? Mission and goals achieved? Financial viable?
- ▶ Cross-cutting aspects = like any other audit, here the main concern is how did the project managers, in their implementation, complied with other governance issues and laws and regulations, standards, values and best practices.

Figure 9: Dimensions in Value for Money Audit (Source: Fölscher, 2007)



8.5 Planning a Value for Money Audit

8.5.1 Identify Audit Concern or Issue with Value for Money (VFM) Audit

In VFM audit the most challenging phase is to set audit objectives. VFM audit are usually conducted when there is an issues needing answers relating to the performance or settling of value for money concerns (i.e. economy, efficiency or effectiveness of a given project or intervention).

Example:

"It is a concern that good performance of students in science subjects is essential for social and economic development. The aims among others in the Government's Education Policy for secondary school are to achieve equity in education and also, to prepare all students for higher education. Despite these ambitions there are massive failures in mathematics and science subjects in secondary school."

(Source: NAOT Performance Audit Report – 2008)

8.5.2 Develop Audit Questions

In VFM audit, unlike financial audits, the audit objectives are often set out in the form of one overall "audit question" and a limited number of subsidiary questions (i.e. what is needed to be known) or hypotheses (i.e. what is needed to be confirmed). The aim of the VFM audit will be to answer, verify and conclude against these questions. All evidence gathering, data evaluation and analysis are guided by the audit questions.

The questions/objectives that are set should give a clear direction for the audit such that:

- ▶ They define the area to be audited (e.g. Political objectives, grants, government reforms, government services, etc.);
- ▶ Has to define what is to be examined i.e. deviations related to three E's (Economy, Efficiency, Effectiveness); and
- ▶ Could also include the causes (of deviations) and consequences.

Example:

"The specific audit questions are the following:

- ▶ Does the planning by the school inspection genuinely address the problem of poor performing students in secondary schools?
- ▶ Are the school inspections conducted efficiently and effectively, do they address the major performance problems among students in secondary schools, and are essential shortcomings highlighted in the school inspection reports?
- ▶ Are the results of the inspections findings, conclusions and recommendations effectively communicated to various stakeholders?
- ▶ Are the achievements appropriately monitored and communicated, and are the recommendations given to the headmasters influential and effective?"

(Source: NAOT Performance Audit Report – 2008)

Posing questions incorrectly or asking the wrong questions will inevitably lead to audits going in the wrong direction. By doing it right the auditor can save time by not collecting and analysing less relevant information.

8.5.3 Setting the Audit Criteria

The audit criteria define what the audited entity, project, undertaking, services, program or operation will be judged against (e.g. policies, laws, pre-defined targets, professional standards, public opinion, etc.)

The audit criteria, which can be of a qualitative or quantitative nature, should be reliable, objective, fair, useful, and complete. It is important to be aware of the character of the audit criteria chosen; they may be normative and specific, or may be more general in nature.

The criteria may reflect:

- ▶ What should be according to laws, regulations or objectives;
- ▶ What is expected, according to sound principles and best practice;
- ▶ What could be (given better conditions)?

Example:

The National Audit Office has based on legal document/acts and policy documents to formulate the following assessment criteria:

- ▶ Planning by the school inspection should address the issue of students' performance;
- ▶ Schools with poor performance should be given priority in school inspection program;
- ▶ Priority for school inspections should be set in the annual planning;
- ▶ School inspections should reflect areas of priorities.

(Source: NAOT Performance Audit Report – 2008)

The nature of the audit and the audit questions determines the relevance and the type of suitable criteria.

The following are possible sources of criteria:

- i. The law and regulations;
- ii. Standards developed by recognized professional organizations;
- iii. LGA Reports on Plans and Priorities and Performance Reports;
- iv. Generally accepted good practice;
- v. Standards established by the audited organization;
- vi. Measures developed specifically for the audit by adapting criteria used in similar engagements or by reference to standards and practices of other organizations carrying out similar activities; and prior work of the LGA.

8.5.4 VFM Audit Approaches

In formulating the audit methodology, involves the following key considerations:

- i. Define how to get the information you need;
- ii. Define how to analyse the collected information;
- iii. Where can we get the data we need – sources?
- iv. How do we collect the data? (Document, data registers, interviews, questionnaire, observations, pictures, etc.

Again, the audit questions set in section above are the major determinant of the audit approach.

There are generally two approaches in conducting a VFM Audit:

- i. Auditing results directly.
 - ▶ This type of audit focuses on assessing the results achieved in relation to those intended.
 - ▶ The audit does not initially examine the details of the methods or processes but looks at the outputs or outcomes themselves.
 - ▶ The approach is particularly appropriate where there are suitable criteria available to measure the quality, quantity and cost of the outputs.
 - ▶ The types of problems that may be identified include:
 - Services that are not in accord with the program mandate;
 - Unit costs that exceed departmental standards, or costs of comparable activities in other sections of the government or in outside organizations, and
 - Goods or services that do not meet standards of quality or quantity.
- ii. Auditing the control systems.
 - ▶ This approach is designed to determine if the organization has adequate control systems to provide reasonable assurance that the intended results are achieved.
 - ▶ This approach focuses initially on systems and controls and later proceeds to the assessment of the output and outcome of the project.
 - ▶ Normally, only high-risk components of the system would be reviewed in depth. Controls are chosen for audit on the basis of their significance to the achievement of key results.

8.6 Fieldwork in VFM Audit

8.6.1 Question on Fieldwork

The fieldwork in VFM audit is the execution phase, where auditors embark in obtaining the appropriate and sufficient evidences to support the findings and conclusions of the audit.

The focus on fieldwork is to collect data that will answer the audit questions established during the planning stage.

Borrowing from auditor's dimensions discussed in Figure 9 above, the auditors will be collecting evidence against the established criteria on each of the components of VFM i.e. the 3 Es and crossing -cutting issues i.e.:

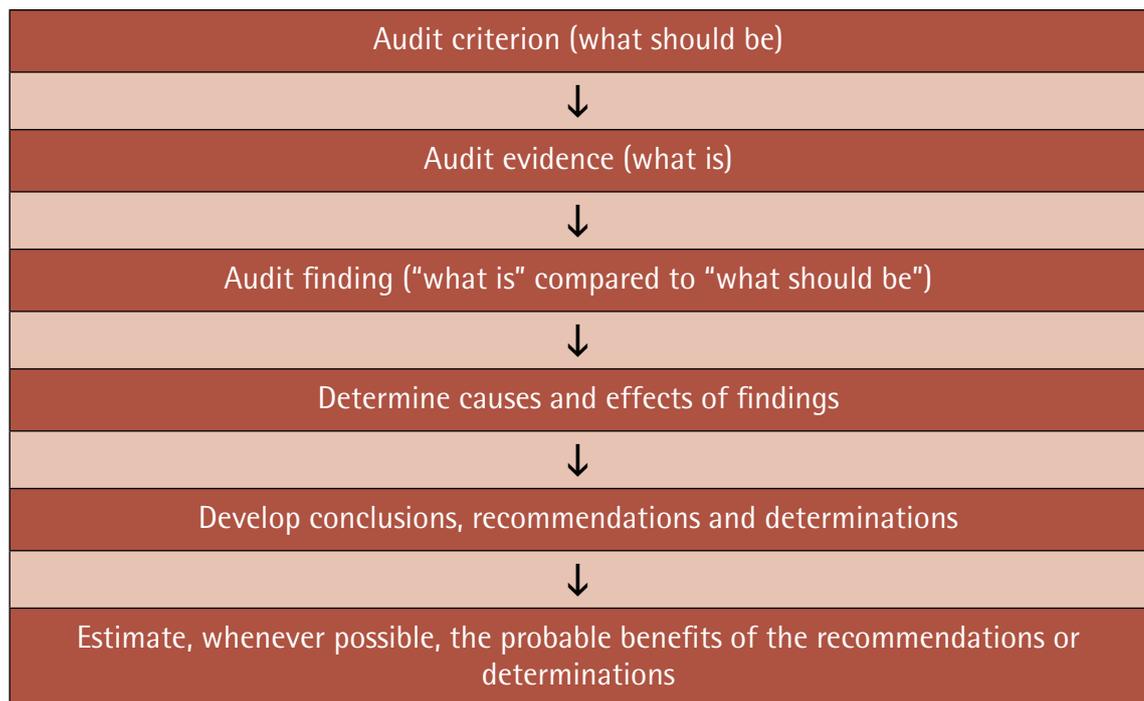
- i. Economy = how the project use their funds to procure inputs (e.g. Staff time, and other resources). The main issues would be on amount, timing, price, quantity and quality of resources procured.
- ii. Efficiency = how inputs are used to produce outputs (goods & services). Question the input/output in terms of wastage, timeliness, quantity, quality, and customer satisfaction.
- iii. Effectiveness = how the outputs produce outcomes (i.e. effects on users). Main issue would be are the original intentions/objectives met? Mission and goals achieved? Financial viable?

- iv. Cross-cutting aspects = like any other audit, here the main concern is how did the project managers, in their implementation, complied with other governance issues and laws and regulations, standards, values and best practices.

8.6.2 Developing an Audit Findings in VFM

As in any other type of audit, VFM finding is the discrepancy between the existing situation and the criterion. Findings are situations verified by the auditor during the field-work that will be used to answer audit questions. The audit finding occurs when the criterion is compared to the existing situation.

Figure 10: Process of Identifying Findings and Developing Recommendations (ISSAI 3000: 2004)



As summarised in Figure 10, an audit finding is developed by collecting evidence on the condition (what is) against the established criterion (what should be).

The comparison between the two is the audit finding (especially a discrepancy between the criterion and the condition).

8.7 VFM Audit Report

8.7.1 Structure of VFM Report

There is no definite structure of a VFM audit report. However, a VFM audit report must clearly communicate to the readers the following aspects of the assignment:

- ▶ The objectives, nature, time period covered by the audit, and scope of the audit, including any limitations;
- ▶ The professional standards used;
- ▶ A description of the program or activity that was audited, including management's responsibilities;

- ▶ The criteria used and any disagreement with management on their suitability;
- ▶ The observations made;
- ▶ The recommendations made to guide corrective action;
- ▶ Management comments (if provided) including planned action in response to the audit and any differences of opinion; and
- ▶ The conclusions reached against each audit objective.

8.7.2 Reporting a VFM Finding

Of particular importance is the structuring of the observation or findings part of the report. In VFM, the focus is on the 4 attributes of a finding; hence the reporting of a finding must reflect the following attributes:

- ▶ Criterion (what should be);
- ▶ Condition (what is);
- ▶ Cause (reason for detour from deviation from the criterion); and
- ▶ Effect (a consequence of the situation found).

Example:

Figure 11: Example of Four Attribute VFM Audit Finding for Reporting

Finding:

- ▶ Lack of enough psychiatric inpatient beds in hospitals in the LGA hospitals.

Criterion:

- ▶ Number of inpatient beds ratio established by the World Health Organisation is 0.43 per thousand inhabitants.

Condition:

- ▶ Hospitals in LGAs have an average of 0.37 psychiatric inpatient beds per thousand inhabitants.

Causes:

- ▶ Uneven distribution of beds between the hospitals in the LGAs.
- ▶ Distribution of beds does not meet the population criteria.
- ▶ Lack of municipal and National mental health plans incipient social control.

Effects:

- ▶ Deficiency of service in places with low beds rates.
- ▶ Migration of people with mental disorders among municipalities, complicating the planning of health care.

Source: Adopted from Brazilian Court of Audit (2010)

8.8 Review Questions

- i. Define the following terms: value for money audit, economy, efficiency and effectiveness?
- ii. Do you think a project can be effective but not efficient? Explain why or how?
- iii. Discuss the key issues lead to the need of value for money in LGAs.

- iv. What are the two dimensions of value for money in any given project? Explain each dimension.
- v. In your group, develop a performance issue or concern in respect of a program or project in your LGA. From this issue formulate:
 - ▶ Main VFM audit questions and sub-questions.
 - ▶ Establish key criterion for assessing the performance of this project based on each aspect of the input, process, and output and outcome of the project.
 - ▶ Formulate the key audit approach/methodology and type of data you will need to collect.

Session 9

9 IT Audits

9.1 Introduction

Computers or information technology (IT) can provide more effective information systems through rapid and reliable information processing.

IT today is provided by a wide range of facilities, it includes all sizes of computers (from hand-held data capture units, through personal computers and local networks, to the largest mainframes and 'supercomputers'), FAX machines, programmable photocopiers and printing machines, telephones and communications networks.

9.2 Learning Objectives

By the end of this session the participants should be able to:

- ▶ Understand the need for IT audits;
- ▶ Explain the two types of internal controls in computerised environment;
- ▶ Explain the dimensions and element of IT audit;
- ▶ Explain the IT audit process and IT audit techniques.

9.3 Definitions

IT/IS Audit

Information Technology/Information system audit is the process of collecting and evaluating evidence to determine whether a computer system (information system) safeguards assets, maintains data integrity, achieves organizational goals effectively and consumes resources efficiently.

Source: Sayana (2002)

9.4 Need for IT Audit in LGAs

Regulation 34 (1) (h) of the Public Finance Regulations (2001) as amended in 2010 provides:

“Internal audit service... shall review and report on the adequacy of controls built into computerized systems in place within the unit”.

The need for internal auditors to provide assurance with regard to IT adoption and use in LGAs may be viewed from two aspects i.e. the increasing adoption and application of IT in LGA/government activities; and the potential risks posed by these applications.

9.4.1 Increasing use of IT in LGAs

Over the recent years, IT is increasingly occupying the largest share of government's activities hence representing the government's most valuable assets.

For example, computerization of the government (MDAs and LGAs) includes:

- ▶ Accounting function through Epicor accounting software (Integrated Financial Management System - IFMS);
- ▶ Human resources management information system (LAWSON);
- ▶ Planning and Reporting Software (PlanRep);
- ▶ Intranets/internets etc. to enable quality management of information and facilitating speedy decision making.

9.4.2 IT-related Risks

The risk of poor information system and unreliable security and back-up arrangements leads to the following problems:

- ▶ Possible fraud and errors;
- ▶ Non-compliance with privacy or data protection rules;
- ▶ Customer dissatisfaction;
- ▶ Security breaches;
- ▶ Theft of proprietary information;
- ▶ Abuse of internet access;
- ▶ Denial of services;
- ▶ Viruses;
- ▶ Sabotage of data or networks;
- ▶ System penetration/unauthorised access;
- ▶ Spoofing.

9.5 Objectives of IT Audit

The objectives for conducting IT audits concentrate on substantiating that internal controls exist and are functioning as expected to minimize all the IT-related risks (see section above).

To be specific, Sayana (2002) explain that the purpose of IT audit is to review and provide feedback, assurances and suggestions on the following key issues:

i. Availability

- ▶ Will the information systems on which the LGA is heavily dependent be available at all times when required?
- ▶ Are the systems well protected against all types of losses and disasters?

ii. Confidentiality

- ▶ Will the information in the systems be disclosed only to those who have a need to see and use it and not to anyone else?

iii. Integrity:

- ▶ Will the information provided by the systems always be accurate, reliable and timely?
- ▶ What ensures that no unauthorized modification can be made to the data or the software in the systems?

9.6 Dimensions of IT Audit

IT audit is divided into two main dimensions, which also categorises the types of IT auditors namely:

- ▶ Review of Management Information System (MIS); and
- ▶ Review of computer systems.
- ▶ These two dimensions also divides IT internal auditor into two types:
 - ▶ Generalist internal auditors (i.e. those with general knowledge with ability to only review the MIS); and
 - ▶ Specialist computer auditors/IT auditors (i.e. with specialised skills to review the computer systems).

This session is mainly concerned with the generalist approach to IT audit.

9.7 Internal Control in a Computerized Environment

The principles relating to internal control are the same in a computerized environment as in a manual environment.

However, in computerised environments, controls are categorised into two main groups:

- ▶ Application controls; and
- ▶ General controls.

9.7.1 Application Controls

Application controls relate to the transactions and standing data for each computer-based application and are therefore specific to each application.

An application is a computer-based system which processes data for a specific business purpose.

Few examples of some application systems:

- ▶ General Ledger
- ▶ Fixed Assets
- ▶ Inventory Control
- ▶ Sales
- ▶ Human Resources
- ▶ Payroll
- ▶ Etc.

The objectives of application controls are to ensure that the information produced by the system is complete, accurate and valid.

To achieve these objectives controls will be needed over:

- ▶ The completeness, accuracy and authorization of all input to the system;
- ▶ The completeness and accuracy of the data processing;
- ▶ The accurate maintenance of master files and associated standing data.

9.7.2 General Controls

General controls relate to the environment within which computer-based systems (applications) are developed, maintained and operated.

Thus they are generally applicable to all computer systems within an organization. The purpose of general controls is to ensure the proper development and implementation of computer applications and operations.

General controls cover four main areas:

- ▶ Procurement- the selection and purchase of computer hardware (the computers) and computer software (the programs to run on the computers);
- ▶ Systems development-controls over the development of new computer software of applications or of upgrading such programs;
- ▶ Administration – separation of duties, access control (use of passwords etc.), stand by and back up facilities, controls over files and personnel;
- ▶ Documentation – existence of standards/policy, manuals, operating instructions and disaster plans.

9.8 Elements of IT Audit

Assurances about an information system can be obtained only if all the components are evaluated and secured.

The major elements of IT audit can be broadly classified:

- i. Physical and environmental review
 - ▶ This includes physical security, power supply, air conditioning, humidity control and other environmental factors.
- ii. System administration review
 - ▶ This includes security review of the operating systems, database management systems, all system administration procedures and compliance.
- iii. Application software review
 - ▶ The business application could be payroll, invoicing, a web-based customer order processing system or an enterprise resource planning system that actually runs the business.
 - ▶ Review of such application software includes access control and authorizations, validations, error and exception handling, business process flows within the application software and complementary manual controls and procedures.
 - ▶ Additionally, a review of the system development lifecycle should be completed.
- iv. Network security review
 - ▶ Review of internal and external connections to the system, perimeter security, firewall review, router access control lists, port scanning and intrusion detection are some typical areas of coverage.
- vi. Business continuity review
 - ▶ This includes existence and maintenance of fault tolerant and redundant hardware, backup procedures and storage, and documented and tested disaster recovery/ business continuity plan.

vii. Data integrity review

- ▶ The purpose of this is scrutiny of live data to verify adequacy of controls and impact of weaknesses, as noticed from any of the above reviews. Such substantive testing can be done using generalized audit software (e.g., computer assisted audit techniques).

It is important to understand that each audit may consist of these elements in varying measures; some audits may scrutinize only one of these elements or drop some of these elements.

While the fact remains that it is necessary to do all of them, it is not mandatory to do all of them in one assignment.

The skill sets required for each of these are different. The results of each audit need to be seen in relation to the other. This will enable the auditor and management to get the total view of the issues and problems.

9.9 The IT Audit Process

9.9.1 Preliminary Evaluation

The first step in IT Audit should be preliminary evaluation of the computer systems covering:

- ▶ How the computer function is organised;
- ▶ Use of computer hardware and software;
- ▶ Applications processed by the computer and their relative significance to the organization; and
- ▶ Methods and procedures laid down for implementation of new applications or revision to existing applications.

9.9.2 Choice of Audit Methodology

After completing the preliminary evaluation of the computer systems, the auditor has to decide about the appropriate audit approach; system based or directs substantive testing. In doing so, the aspects to be borne in mind are:

- ▶ Results of the preliminary evaluation;
- ▶ Extent to which reliance can be placed on any work carried out by Internal Audit; and
- ▶ Nature of any constraints like lack of any audit trail and the practicability of testing.

ii. Direct Substantive Testing

- ▶ If Direct Substantive Testing approach is chosen, a sample of transactions should be selected and tested.
- ▶ Result of the preliminary evaluation will be of help particularly as it would have:
 - Provided an overall assessment of the control environment and identified any serious weaknesses which should be raised with the auditee;
 - Given sufficient familiarity with the system to be able to decide the point from which to select the transactions for testing and how to substantiate them efficiently; and
 - Provide sufficient information to determine any initial requirement for any CAATs.

iii. Systems Based Audit

- ▶ For System Based Audit approach, aspects of regularity, economy, efficiency and effectiveness of the system have to be looked into besides evaluating data integrity, and data security as explained below:
 - System effectiveness is measured by determining whether the system performs the intended functions and whether users get the needed information, in the right form when required;
 - A system is economical and efficient if it uses the minimum number of information resources to achieve the output required by the users. The use of system resources - hardware, software, personnel and money - should be optimized;
 - System activities would be regular if they comply with applicable laws, rules, policies, guidelines etc.;
 - Achieving data integrity implies that the internal controls must be adequate to ensure that error are not introduced when entering, communicating, processing, storing or reporting data; and
 - Data system resources, like other assets, must be sufficiently protected against theft, waste, fraud, unauthorized use and natural disasters;
 - The key controls for ensuring the above will have to be identified, recorded, evaluated and compliance tested. The result of the preliminary evaluation would be of help particularly as they would indicate system deficiencies, major weaknesses and the areas requiring in-depth study;
 - Identification of key controls would also depend on experience of the auditor gained in course of audit of similar installations.

9.10 IT Audit Techniques

IT audit techniques refer to the use of computers, including software, as a tool to independently test computer data of audit interest. Some well-established techniques are:

- i. Collecting and processing a set of test data that reflects all the variants of data and errors which can arise in an application system at different times;
- ii. Using integrated test facilities, built into the system by the auditee to help the auditor in his requirements, as one of the users of the system;
- iii. Simulating the auditee's application programs using audit software to verify the results of processing;
- iv. Reviewing program listings periodically to see that there are no unauthorized alterations to the programs;
- v. Using either commercial software or in-house developed programs to interrogate and retrieve data applying selection criteria and to perform calculations and;
- vi. Extracting samples of data from the auditee database/files, using sampling techniques, for post analysis and review.

The nature of data and type of analysis required determine what technique is to be employed. The auditor should give the sample size and design. Computer audit techniques are employed for:

- i. verification of ledger balances and control totals independently;
- ii. Recalculation of critical computerized calculations to check mathematical correctness;

- iii. Range checks to verify the working of computer based controls and testing for exception conditions;
- iv. Testing the validity of data which have gone into the master file;
- v. Detection of data abuse/frauds.

9.11 Review Questions

- i. Define application control and general controls in relation to IT audit;
- ii. What are key elements of an IT auditing?
- iii. Based on the control objectives for IT as well as issues on IT audit discussed in Chapter 7 item 7.6.5 of the LGA Internal Audit Manual, consider issues for inclusion in the audit program for auditing Epicor, LAWSON or PlanRep for the following:
 - ▶ Administration Controls
 - ▶ Application Controls
 - ▶ Data Processing Controls
 - ▶ Standing Data Controls.

Session 10

10 Fraud Investigations

10.1 Introduction

This session is discusses in broad terms the overview of fraud, its definition as well as how can it be detected and managed. It also discusses the responsibility of internal auditors in relation to detection and prevention of fraud.

10.2 Learning Objectives

By the end of the session, participants should be able to:

- ▶ Explain the meaning of fraud;
- ▶ Explain the reasons as to why staff commit fraud and the measures to prevent it;
- ▶ Understand responsibility of internal auditors in fraud detection and prevention;
- ▶ Conduct the fraud investigation process (i.e. planning, fieldwork and report).

10.3 Definitions

The following definitions are important in this session:

Fraud

Fraud is the deliberate misrepresentation of fact for the purpose of depriving an organization permanently of property or legal right to property with the intention of obtaining an unauthorized benefit.

Fraud triangle

The interconnected conditions that act as harbingers to fraud: opportunity to commit fraud, incentive (or pressure) to commit fraud, and the ability of the perpetrator to rationalise the act.

Investigation

A formal fact finding enquiry to examine allegations of misconduct and wrongdoing in order to determine whether they have occurred and if so, the person or persons responsible.

10.4 Theory of Fraud

This section presents some of theoretical underpinnings of fraud, mainly on arguments on why people commit fraud, the profile of a fraudster, and some of the common types of frauds committed in the public sector.

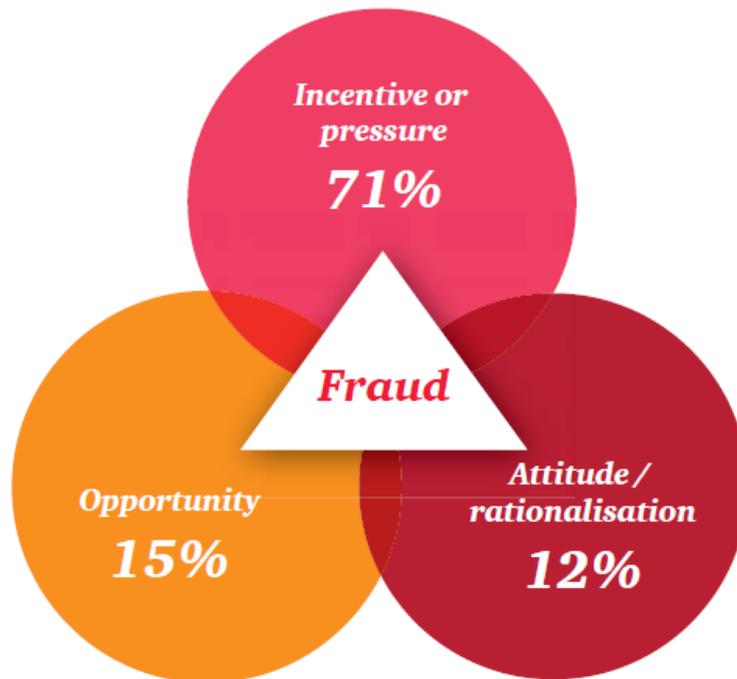
10.4.1 Why do People Commit Fraud?

Explains on why people commit frauds have said to be a result of three main antecedents namely:

- ▶ Incentive (or pressure);
- ▶ Rationalisation (or attitude); and
- ▶ Opportunity.

These three factors leading to an individual to commit fraud have usually been explained by what is known as “the fraud triangle” (see Figure 12).

Figure 12: The Fraud Triangle on why do People commit Fraud (Source: PWC, 2011)



The explanations on the fraud triangle simply say that for an individual to commit fraud, a the one of the factors is an incentive to do so or pressure of life that the individual is undergoing (e.g. need of money to finance personal needs like rent, schools fees etc., involvement in high spending life style beyond the means, or gambling, drug use etc.). According to a survey by PWC (2011) incentive and pressures of life contribute about 71% to individual’s committing a fraud (see Figure 12).

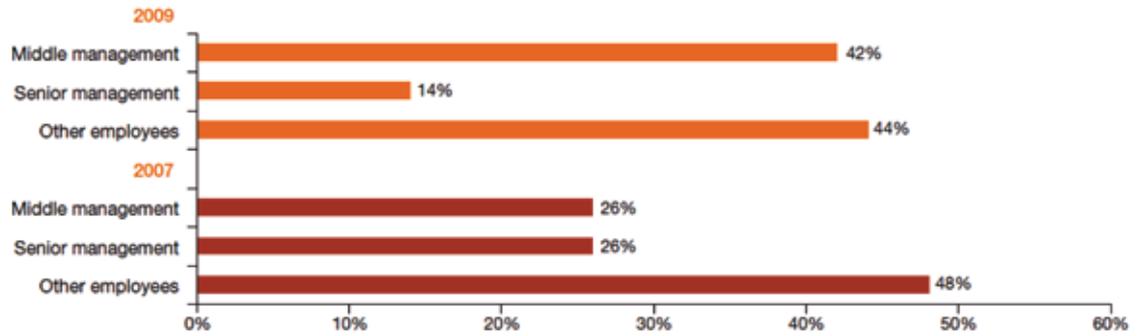
If this pressure of life is coupled with an individual’s personal attitude or rationalisation (i.e. perception of whether fraud is wrong or right), the only thing that is hindering this individual to commit fraud is an opportunity to do so. An opportunity in this case, means a possible weakness in the organisation’s internal control.

Rationalisation and opportunity, according to the PWC survey in Figure 12, contributes about 12% and 15% on why individuals commit fraud.

10.4.3 Who Commits Fraud in Public Sectors

Fraud is more likely to be committed by internal people (than external), and it is usually committed by trusted employees. Based on the PwC Survey (2011), government entities around the globe that suffered from economic crime reported that 57% of perpetrators were internal while only 37% were external. It is therefore true to say that fraud in public sector organisations is more of an internal threat than an external. This is because an insider and a trusted employee have more knowledge of the LGA and its system of control including weak areas, which in is this case, presents an opportunity for fraud.

Figure 13: Profile of an Internal Fraudster (PWC, 2011)



Again, looking at the profiles of internal fraudsters in the public sector, the survey indicated that other employees and people at middle management level are increasingly becoming more likely to commit fraud than senior management (see Figure 13 with data from 2007 to 2009).

! The most common types of fraud in public sector are:

- ▶ Using false/forged receipts to claim travel, stationary, fuel or/and accommodation allowances;
- ▶ Removing and selling assets or items;
- ▶ Receiving bribes or kickbacks or referring contract work to past employees;
- ▶ Colluding in the tendering process with bidders and contractors;
- ▶ Directing contracts to companies they had established;
- ▶ Colluding with contractors on setting the contract price above the actual price estimations by the contractors;
- ▶ Etc.

10.5 Role of Internal Audit in Fraud

The role that internal audit unit plays with regard with fraud emanates from the definition of internal auditing i.e. “to provide assurance and consulting services” to the LGA management that fraud related risks are well managed.

It is the management’s responsibility to assess the risk of fraud and design an internal control system that will prevent and detect risks. The internal auditor’s role is to evaluate the control system (as put in place by management) and provide recommendations on its effectiveness and need for improvement.

The following IIA standards give specific considerations on internal auditors’ role with regard to fraud:

- ▶ PS 1210.A2 – Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.
- ▶ PS 1220.A1 – Internal auditors must exercise due professional care by considering the:
 - Extent of work needed to achieve the engagement’s objectives;
 - Related complexity, materiality, or significance of matters to which assurance procedures are applied;

- Adequacy and effectiveness of governance, risk management, and control processes;
 - Probability of significant errors, fraud, or noncompliance;
 - Cost of assurance in relation to potential benefits.
- ▶ PS 2120.A2 – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.
 - ▶ PS 2210.A2 – Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.

10.6 Potential Fraud Indicators

10.6.1 Personal Red Flags

Fraudsters often display certain behaviours or characteristics that may serve as warning signs or red flags.

Example of personal red flags:

- ▶ Some perpetrators act unusually irritable;
- ▶ Some suddenly start spending lavishly; and
- ▶ Some become increasingly secretive about their activities;
- ▶ Living beyond one's means;
- ▶ Conveying dissatisfaction with the job to fellow employees;
- ▶ Unusually close association with suppliers;
- ▶ severe personal financial losses;
- ▶ Addiction to drugs, alcohol or gambling;
- ▶ Change in personal circumstances; and
- ▶ Developing outside business interests.
- ▶ Providing unreliable communications and reports,
- ▶ Rarely take vacations or sick time (and when they are absent, no one performs their work).

10.6.2 Management/System Red Flags

At the management level, the red flags include:

- ▶ Overrides of controls by management or officers;
- ▶ Irregular or poorly explained management activities;
- ▶ Consistently exceeding goals/objectives regardless of changing business conditions and/or competition;
- ▶ Preponderance of non-routine transactions or journal entries;
- ▶ Problems or delays in providing requested information; and
- ▶ Significant or unusual changes in customers or suppliers;
- ▶ Transactions that lack documentation or normal approval;
- ▶ Employees or management hand-delivering checks;
- ▶ Customer complaints about delivery and poor IT access controls such as poor password controls.

These red flags are often indicators of misconduct, and an organization's management and internal auditors need to be trained to understand and identify the potential warning signs of fraudulent conduct.

10.7 Fraud Investigation Process

Fraud investigation starts with a concern or suspicion of wrongdoing within the organization. The suspicions can result from a formal complaint process, informal complaint process such as tips, or an audit, including an audit designed to test for fraud.

10.7.2 Accepting the Assignment

Upon such suspicion, the LGA management will probably audit team of investigators, which could include internal auditors and other staff. The appointment will be a form of a letter with specific Terms of Reference (ToRs) for the Team to accomplish.

If the internal audit unit is appointed to investigate, or be among the investigation team, the first thing to consider is whether their unit has the necessary skills and experience to accept the assignment. This is because the nature of suspected fraud may not of financial nature and therefore require specific expertise.

10.7.3 Planning

The planning and subsequent management of fraud investigation is critical to a fair and effective outcome. The investigating team must carefully consider what they have been asked to achieve in the ToR and plan their work accordingly.

The objectives of the investigation will include:

- ▶ Identifying the type of fraud that has been operating, how long it has been operating for, and how the fraud has been concealed;
- ▶ Identifying the fraudster(s) involved quantifying the financial loss suffered by the LGA;
- ▶ Gathering evidence to be used in court proceedings;
- ▶ Providing advice to prevent the re-occurrence of the fraud.

The investigators should also consider the best way to gather evidence – the use of computer assisted audit techniques, for example, is very common in fraud investigations.

At the planning stage, the team need to obtain a clear understanding of the activity involved in the fraud, and possible suspects. Based on the ToR, the team will have to come up with a plan on how each is going to be achieved.

10.7.4 Gathering Evidence

In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered.

It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Evidence can be gathered using various techniques, such as:

- ▶ Testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated;
- ▶ Using analytical procedures to compare trends over time or to provide comparatives between different segments of the business;
- ▶ Applying computer assisted audit techniques, for example to identify the timing and location of relevant details being altered in the computer system;
- ▶ Discussions and interviews with employees;
- ▶ Substantive techniques such as reconciliations, cash counts and reviews of documentation.

The ultimate goal of the forensic investigation team is to obtain a confession by the fraudster, if a fraud did actually occur.

The investigators are likely to avoid deliberately confronting the alleged fraudster(s) until they have gathered sufficient evidence to extract a confession.

10.7.5 Evidence Analysis

Upon gathering the evidence, the investigators will review and categorize the information collected, document and track every step in the investigation.

Appropriate documentation covers privileged or confidential items; requests for documents, electronic data and other information; memoranda of interviews; and analysis of documents, data, interviews and conclusions drawn.

10.7.6 Reporting

The LGA management, as one of the ToR, will expect a report containing the following aspects:

- ▶ The findings of the investigation;
- ▶ A summary of evidence and;
- ▶ Discussion on how the fraudster set up hi/her scheme and the controls which were circumvented;
- ▶ Conclusion as to the amount of loss suffered as a result of the fraud.
- ▶ Recommendation to improve controls within the LGA so that to prevent any similar frauds occurring in the future.

10.8 Review Questions

- i. Define fraud.
- ii. Explain why people commit fraud.
- iii. Mention the red flags frauds both individuals and management.
- iv. Explain the roles and responsibilities of the internal audit unit in preventing and detecting risks.
- v. In your group, list the most common types of frauds that may be committed by LGAs employees, and ways of preventing or detecting them.

Session 11

11 Maintaining Quality of the Internal Audit Unit

11.1 Introduction

To be able to provide value to the LGA, the quality of internal audit unit must be constantly monitored and maintained. This is a professional requirement by the IIA, needing internal audit units to maintain Quality Assurance and Improvement Programs.

This session introduces the participants to the basics of quality assurance in internal auditing.

11.2 Learning Objectives

The session main objective is to enable the participants to understand and apply the principles of quality assurance in their internal audit units.

It is expected that, at the end of this sessions, the participant will be able to:

- ▶ Explain the need for maintaining the quality of internal audit units;
- ▶ Explain the IIA standards and requirement for quality assurance;
- ▶ Facilitate quality assurance reviews (internal and external) and reports of their IAUs.

11.3 Why Maintain Quality of the Internal Audit Unit?

Quality assurance for internal audit units is seen to be of the following advantages:

- i. The LGA management becomes assured that the internal audit unit is complying with globally recognized standards;
- ii. Affirm that internal audit is serving as a reliable source of information for risk, control and governance within the LGA;
- iii. It will be able to make comparison of the performance of the internal audit unit with that of its peers in other LGAs;
- iv. A means to determine whether internal audit has the right reporting structure, people and skill sets to address the LGA assurance needs;
- v. Assess key stakeholder expectations, e.g., what values they expect to gain from internal audit;
- vi. Determine whether internal audit processes and practices are aligned effectively with stakeholder expectations; and
- vii. Explore how to raise the stature and visibility of the internal audit unit in the LGA.

11.4 IIA's Standards on Quality Assurance

The IIA has issues specific standards for quality assurance. The IIA requires head of internal audit units to establish a quality assurance and improvement program.

To be specific, Performance Standard 1300 specifies that an effective quality assurance and improvement program should include three key components:

- ▶ Ongoing monitoring of the performance of the internal audit department (IIA Standard 1311);
- ▶ Periodic internal assessments of the internal audit department's conformance to IIA Standards (IIA Standard 1311);
- ▶ External assessments that should be "...conducted at least once every five years by a qualified independent reviewer or review team from outside the organization".

11.5 Internal Quality Assurance

Internal quality assurance can be divided in two i.e.: ongoing monitoring of performance of internal audit unit, and periodic internal assessments.

11.5.1 Ongoing Monitoring of Performance of IA Unit

This is done in a variety of ways, and it is a natural management responsibility of the head of internal audit unit and the LGA senior management at large as part of their oversight role.

The head of internal audit unit should design a methodology to enable an evaluation of the internal audit unit's conformance with definition of internal audit and the Standards, and whether internal auditors apply the Code of Ethics.

Ongoing monitoring/assessments are conducted through:

- ▶ Establishment and conformance to internal audit charter;
- ▶ Establishment of Audit Policies and Procedures used for each engagement to ensure compliance with applicable planning, fieldwork and reporting standards;
- ▶ Proper supervision of audit engagements;
- ▶ Regular, documented review of work papers during engagements by appropriate Internal Audit staff;
- ▶ Feedback from customer survey on individual engagements; and
- ▶ All final reports and recommendations are reviewed and approved by a Head of Internal Audit Unit.

11.5.3 Periodic Internal Assessments

Periodic assessments are designed to assess conformance with Internal Audit's Charter, the Standards, Definition of Internal Auditing, the Code of Ethics, and the efficiency and effectiveness of internal audit in meeting the needs of its various stakeholders.

Periodic assessments are conducted through:

- ▶ Bi-annual customer survey;
- ▶ Annual risk assessments for purposes of annual audit planning;
- ▶ Semi-annual work paper reviews for performance in accordance with internal audit policies and with the Standards; and
- ▶ Periodic activity and performance reporting to the Executive Director and the Audit Committee.

11.6 External Quality Assessments

External assessments, which should be conducted every five years, are designed to appraise and express an opinion about internal audit's conformance with the Standards, Definition of Internal Auditing and Code of Ethics and include recommendations for improvement, as appropriate.

External reviews should be conducted by a team of competent professionals from outside the LGA i.e. the reviewer should neither be an employee of the LGA nor from any other associated party.

The external assessment consists of a broad scope of coverage that includes the following elements of Internal Audit Unit:

- ▶ Conformance with the Standards, Definition of Internal Auditing, the Code of Ethics, and internal audit's Charter, plans policies, procedures, practices, and any applicable legislative and regulatory requirements;
- ▶ Expectations of Internal Audit as expressed by the full council, executive management, and operational managers;
- ▶ Integration of the Internal Audit activity into governance process, including the audit relationship between and among the key groups involved in the process;
- ▶ Tools and techniques used by Internal Audit;
- ▶ The mix of knowledge, experiences, and disciplines within the staff, including staff focus on process improvement; and
- ▶ A determination whether Internal Audit adds value and improves the LGA's operations.

11.7 Reporting on Quality Assessments

Results of internal assessments should be reported to the Audit Committee and to the senior management at least annually.

Results of external assessments should be provided to the senior management and the Audit Committee.

The external assessment report must be accompanied by a written action plan in response to significant comments and recommendations contained in the report.

The head of internal audit unit should implement appropriate follow-up actions to ensure that recommendations made in the report and action plans developed are implemented in a reasonable timeframe.



The Ministry of Finance through the IAGD has issued specific guidelines on how to develop Quality Assurance and Improvement Program (QAIP) in the public sector organizations.

The Guidelines should be read in conjunction with this session, so as to obtain specimen of forms, table and sheets.

11.8 Review Questions

- i. What do you understand by the term “quality assurance and improvement program”?
- ii. What are the advantages of assuring the quality of internal audit unit?
- iii. Mention the types of quality assessment? How is each conducted?

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